VOLUME 8 • NUMBER 2
COMPLETE TABLE OF CONTENTS • PAGE 65
INDEX OF CURRENT CASES • PAGE 129

THE JOURNAL OF Taxation

A NATIONAL JOURNAL OF CURRENT NEWS & COMMENT FOR PROFESSIONAL TAX MEN

RECEIVED
JAN 18 1958
J. F. W., Jr.

LIBRARY
FEB 22 1972
Texas A&M University

How to determine basis of partners' interest from accounting records

by Bouldin S. Mothershead

Methods of using loss carryovers: safe, doubtful, and forbidden

by James A. Cuddihy

Beware tax-saving gimmicks in planning estate of middle-income client

by Paul F. Icerman

February 1958

Providing for widow's disclaimer without gift tax 68

Current trends in capitalizations and recapitalizations 75

Special tax-deduction problems of professional men 81

Tax-free annuities for employees of charities under attack 84

When preparing client's return, prepare for examination 85

Planning to get full tax benefit from operating loss deduction .. 88

IRS insists subscriptions are income when received 93

Market drop creates problems in changing stock options 98

Public control of pension funds foreseen by Berle 99

Tax advantages and hazards of personal holding company status 101

No fundamental changes in Tax Court structure needed 106

How IRS audits of tax returns could be improved 109

When should a foreign holding company be utilized? 118

AICPA urged to take active role in settling tax policy 124

N. Y. real property assessment procedure criticized 127

ALL TAX DECISIONS, COURT ACTIONS, REVENUE RULINGS ISSUED EACH MONTH ARE SUMMARIZED IN THE DEPARTMENT COVERING THE POINT AT ISSUE

Just Published: PRACTITIONER'S GUIDE NO. 4

"How to organize the close corporation to minimize taxes (revised)"

Here is a handbook which presents, in consolidated, easy-to-work form, the important material on tax aspects of the close corporation which has appeared in *The Journal of Taxation* up to autumn of 1957.

This Guide No. 4 is a revision and up-dating of Guide No. 1. Approximately 50% larger (96 pp.), new material has been added, new decisions added and obsolete ones removed. The new Guide No. 4 takes into account events up to September 1957, including analysis of the important *Putnam* and *Gooding* decisions. The present very confused state of the thin incorporation is covered.

Use of the small corporation is, of course, one of the standard and best methods to reduce taxes. This handbook points out opportunities, dangers, and discusses the various methods of getting money into and out of the close corporation at least tax cost.

Answers These Important Questions:

- **How to handle thin incorporation since *Putnam* and *Gooding***
- **How to set up the close corporation**
- **How to get money out at minimum tax cost**
- **How to advance money and get it back at least tax cost**
- **Advantages of the corporate form for tax purposes**
- **And many others**

THE PRACTITIONER'S GUIDE SERIES

This is the fourth in a series of guides for tax men. Each is a concise handbook containing all the significant material on a particular subject which has been published in *The Journal of Taxation* during the past year. Each *Guide* contains interpretative articles, summaries of current court decisions affecting that subject, comment by *The Journal's* editors. The purpose is to bring together in an easy-to-use handbook all a practitioner needs to know to orient himself on the current picture of that subject. It is intended to eliminate hours of searching, looking up, gathering together from diverse sources, the material needed to get the current picture. This *Guide* now offered you is 96 pages, 6 x 9 inches, paper cover, sells for $2.

PRACTICAL HANDBOOKS OF CURRENT TAX INFORMATION FOR THE LAWYER, ACCOUNTANT AND BUSINESSMAN

"How to Organize the Close Corporation . . ." is the fourth of the *Practitioner's Guides.* The second is *"Everyday Tax Planning to Increase the Family's Spendable Income Today."* It is 144 pages, paper cover, price $2.95 per copy. The third is *"Tax Fraud: What the Practitioner Needs to Know to Protect His Client."* It is 96 pages, paper cover, price $2 per copy.

ORDER FROM: The Journal of Taxation, Inc., 147 East 50th St., New York 22. Write number of each item wanted on your letterhead, attach check, and mail.

$15 PER YEAR • $1.25 PER COPY
FEBRUARY 1958 • VOL. 8 • NO. 2

THE JOURNAL OF *Taxation*

THE JOURNAL OF TAXATION is published monthly by The Journal of Taxation, Inc. Publication office, 320 North Sixth Street, Paterson 2, New Jersey; editorial office, 147 East 50th Street, New York 22. Telephone PLaza 3-8258. Material for publication is welcomed, either technical manuscripts or news items of interest to professional tax men. While the utmost care will be given material submitted, we cannot accept responsibility for unsolicited manuscripts.
© Copyright, 1957, by The Journal of Taxation, Inc.
Application pending for reentry at Paterson, N. J., March 13, 1956.

EDITOR
WILLIAM S. PAPWORTH

TECHNICAL EDITOR
ELEANOR MCCORMICK, LL.B., CPA

NEW DECISIONS EDITORS
S. A. DYCKMAN, LL.M., CPA, APFEL & ENGLANDER, New York
THEODORE BERGER, LL.B., CPA, Chicago

DEPARTMENTAL EDITORS
JOHN P. ALLISON, LL.B., MARSHALL, BRATTER, GREENE, ALLISON & TUCKER
HARRY GRAHAM BALTER, LL.B., Los Angeles
JACKSON L. BOUGHNER, LL.B., CPA, TENNEY SHERMAN, BENTLEY & GUTHRIE, Chicago
CHARLES J. BUSICK, CPA, THE ANACONDA CO., New York
JOHN COSTELLOE, LL.B., *Tax Director*, RADIO CORPORATION OF AMERICA, New York
PETER G. DIRR, *Vice President*, MCKESSON & ROBBINS, INC., New York
CARL M. ESENOFF, CPA, *partner*: EVERTS AND ESENOFF, San Diego, Calif.
RICHARD L. GREENE, LL.B., *partner*, WHYTE, HIRSCHBOECK & MINAHAN, Milwaukee
BENJAMIN HARROW, J.D., CPA, New York
HERBERT HOWARD, CPA, NIAGARA MOHAWK POWER CO., Syracuse, N. Y.
CHARLES W. LAMDEN, CPA, EVERTS AND ESENOFF, San Diego, Calif.
MARTIN LORE, LL.B., CPA, New York
CHARLES S. LOWRIMORE, SR., CPA, C. S. LOWRIMORE & CO., Wilmington, N. C.
J. A. MANNING, LL.B., New York
SIDNEY I. ROBERTS, LL.B., CPA, ROBERTS & HOLLAND, New York
J. P. STAPCHINSKAS, *Manager*, STATE & LOCAL TAXATION, FORD MOTOR CO., Detroit
JOSEPH TRACHTMAN, LL.B., New York
GODFREY WM. WELSCH, CPA, *partner*: LYBRAND, ROSS BROS. & MONTGOMERY, Dallas
JOHN WILCOX, LL.B., CAHILL, GORDON, REINDEL & OHL, New York

EDITORIAL ADVISORY BOARD
MICHAEL D. BACHRACH, CPA, *partner*: BACHRACH, SANDERBECK & CO., Pittsburgh
CHARLES MELVOIN, CPA, *partner*: ALTSCHULER, MELVOIN & GLASSER, Chicago
ROBERT M. MUSSELMAN, LL.B., CPA, Charlottesville, Va.
MAURICE E. PELOUBET, CPA, *partner*: POGSON, PELOUBET & CO., New York
JAY A. ROBINSON, CPA, *partner*: ROBINSON & WEINBERGER, San Pedro, Calif.
PAUL D. SEGHERS, LL.B., CPA, New York

February contents

REGULAR DEPARTMENTS

Accounting • 88

88 Planning to get full tax benefit from an operating loss deduction, *by Godfrey W. Welsch*

93 IRS insists subscriptions are income when received

93 New accounting decisions

Compensation • 98

98 Market decline creates tax problems in changing stock options

99 Berle forsees public control of administration of pension funds

100 New compensation decisions

Corporate organization • 72

72 Methods of utilizing loss carryovers: safe, doubtful and forbidden, *by James A. Cuddihy*

75 Current tax trends in corporate capitalizations and recapitalizations, *by Richard L. Greene* and *John L. Palmer*

79 New corporate decisions

Estate and gift taxes • 66

66 Estate planning in the middle brackets: beware of unsound tax-saving gimmicks, *by Paul F. Icerman*

68 How to provide for a widow's disclaimer without risking gift tax, *by William J. Bowe*

70 New estate and gift decisions

Foreign taxation • 118

118 The foreign holding company—when should a company organize one? *by Andrew W. Brainerd*

121 New foreign decisions

Fraud • 122

122 Concept of what constitutes tax fraud enlarged

122 New fraud and negligence decisions

Partnerships • 112

112 How to determine basis of partners' interest from conventional accounting records, *by B. S. Mothershead*

116 New partnership decisions

Payroll • 117

117 California sets tax base for disability insurance

Personal tax problems • 81

81 The special tax-deduction problems of professionals, salesmen, the retired, *by Arthur I. Hemmings*

84 IRS and Ways and Means Committee attack annuities for employees of charities

85 When preparing a client's personal return, prepare for examination

85 New decisions affecting individuals

Planning • 101

101 Tax advantages and hazards in operating as a personal holding company, *by Bert L. Klooster*

Policy • 124

124 AICPA urged to take active role in studying, recommending, tax policy, *by John P. Goedert*

Procedure • 106

106 Tax Court is fulfilling its function; no fundamental changes needed, *by J. Edgar Murdock*

109 Methods of improving audits performed by IRS agents discussed, *by Stanley S. Surrey*

110 New procedural decisions

State and local taxation • 127

127 Advisory committee criticizes real property assessment procedure in N. Y.

128 New state and local decisions

Authors in this issue

99 Adolph A. Berle
68 William J. Bowe
118 Andrew W. Brainerd
72 James A. Cuddihy
124 John P. Goedert
75 Richard L. Greene
81 Arthur I. Hemmings
66 Paul F. Icerman
101 Bert L. Klooster
112 B. S. Mothershead
106 J. Edgar Murdock
75 John L. Palmer
109 Stanley S. Surrey
88 Godfrey W. Welsch

Index of new decisions • 129

TAX ASPECTS OF ESTATE PLANNING

Estate & gift taxation

EDITED BY JOSEPH TRACHTMAN & J. A. MANNING

Estate planning in the middle brackets: beware of unsound tax-saving gimmicks

by **PAUL F. ICERMAN**

Too many tax practitioners shy away from estate planning—they regard it as a complicated matter for learned specialists. While the estates of those in the very highest brackets may require a complicated arrangement of powers and trusts, the client of more moderate, though still substantial, means can usually achieve the protection he desires for his family quite simply. Far too many of these men have never given serious thought to the costs of these present unplanned arrangements. It is incumbent upon their tax advisors to raise this problem and suggest solutions. Mr. Icerman considers some typical cases and offers practical, down-to-earth comments on some currently popular forms of estate planning.*

THE SITUATION we are going to discuss here, the facts of which are set out in the adjoining box, presents four problems which the estate planner must attempt to solve. They are:

1. How should the marital deduction be used to achieve maximum benefits?
2. Double or unnecessary tax incidence.
3. Wasted exemptions.
4. Unequal distribution of taxable property as between husband and wife.

Let us look at the question of the use of the marital deduction. Obviously, a bequest to the surviving spouse of all property utilizes all of the marital deduction. In fact, it brings on the second problem involving double tax impact. If property not allowable for the marital deduction passes from one spouse to the other, it is likely to be taxed twice. This must be avoided if at all possible.

In our example, the husband's entire estate of $750,000 goes to his wife at his death. Of this amount $375,000 is taxed, and again is taxed at the death of the wife. To correct this situation, the will could be changed to allow one-half (the maximum marital deduction) to go to the wife. The remaining property would be bequeathed to the children. This one change would reduce the potential tax impact from $267,000 to $173,000. I propose to leave the method of disposition of the part of the estate not taken by the wife until later.

Let us proceed to a discussion of the use of the marital deduction. First, if we wish to take advantage of the maximum marital deduction, how can it be accomplished? Because of the unknown factors as to value and content of the gross estate, planners have resorted to a formula-type bequest. It usually provides for the wife to receive an amount from the estate, which when added to other amounts passing by law or otherwise, will equal one-half of the adjusted gross estate. Many of you have seen this phraesology in wills.

Should marital deduction be used

This leads to the question as to whether the maximum marital deduction should be used in all cases. I know a man who has an estate of about $1,000,000. He has been rather tax-conscious over the years, managing the family finances in such a manner that his wife also has about the same amount of property. Both are over 70 years of age. Each has willed the entire estate to the children. I have not suggested that the wills be changed to utilize the marital deductions, although there could be a sizeable reduction in tax at the death of the first. However, chances are that both deaths will come fairly close together. The saving to the first estate would be offset by an even greater tax on the second.

Ordinarily, the lowest possible tax results if husband and wife have taxable estates of equal size. If husband and wife had estates of $1,000,000 and $400,000 respectively, it might not be advantageous for the husband to provide for the maximum deduction. Such a provision would cause his estate to pay tax on $500,000, while his wife's estate would pay tax on $900,000. Some arrangement for equalizing the estates would probably result in lower tax.

In order for the deduction to be effective, the widow must have or be able to have control over the property used as the basis for the deduction. The possibility of losses through bad investments or remarriage might cause an elderly husband with a young wife, to forego the tax savings and attempt to control the property in a trust.

Let us now return to our example. The first recommendation for change involved a more efficient use of the marital deduction to avoid double tax on part of the estate. Let's take a further look to see what can be done about wasted exemptions. John and Mary each have a $30,000 gift tax exemption and a $60,000 estate tax exemption. If one dies without these exemptions being used, possible tax-free transfers of property have been wasted. As John in this example is the only one of the family with property, it is assumed that there have been no taxable gifts. A gift to his wife would utilize his gift tax exemption, and because of gift tax marital deduction, only one-half counts toward the exemption and tax. The largest tax-free gift to Mary would be $66,000. Suppose this is arranged. John's estate is reduced to $684,000. In the event of his death first and his wife's death second, the tax is $173,000. This represents no reduction from the tax achieved by revising the marital deduction set-up.

Mary now has an estate of $66,000 and

*This article is based on a paper presented at the 11th Annual Alabama Federal Tax Clinic at the University of Alabama.

her death may occur first. She could leave all or part of her property to her husband—thus escaping tax. However, this would put us right back where we were when John dies, as he will be the owner of the entire estate. Mary's will should be revised to have her $66,000 estate pass to the children. This will result in a tax of $220 on her estate, but at the death of her husband the tax will be reduced $23,100, making a net saving of $22,880.

So far, the changes made without the payment of any gift tax have resulted in potential tax saving of $95,000 if the husband dies first and about $23,000 if the wife is first to go. Now the question is, should we proceed further or call it quits?

Let's see what the prospects are if we go on. Remember that Mary has a $30,000 gift tax exemption which has not been used, and also that the taxable estates are out of balance to the extent that if Mary dies first the tax will be $16,000 larger than if John dies first. In order to use the gift tax exemption, there would be no point in Mary making any gifts as her estate presents no problems taxwise. The only profitable way to use her exemption is against John's gifts. This means, of course, that since John's exemption already has been used in the $66,000 gift, a gift tax will be involved. However, a gift reduces the estate tax at its peak rate and is taxed at the lowest rate in the gift tax schedule. Therefore, a gift offers a real possibility for tax reduction in this case.

I think gifts have a proper place, certainly in estate planning, but I think that the other areas should be investigated first. It has been my experience that most people are reluctant to make sizeable gifts to their children, even though substantial savings can be forecast.

However, let's proceed to investigate the tax effect of a gift in our case here. Let's suggest that a trust be established by John with a corpus of $100,000, the income to Mary for life, the remainder to the children. Such a gift would utilize Mary's exemptions, reduce John's estate, but would not reduce their income while Mary lived. I will estimate the gift tax at $5,000. The total estate and gift tax if John dies first will amount to $146,360, and if Mary dies first $159,320. These amounts represent decreases of from $26,000 to $30,000 from the lowest tax amounts we have achieved heretofore. We are still out of balance somewhat. I suggest that this imbalance is not serious, and it can be reduced by allowing Mary's income to accumulate, or by annual gifts from John.

Another possibility is the division of the joint property. If spouses are the same age, joint property may be separated without making a taxable gift. Before this is done, however, some examination as to the time and method of acquisition should be undertaken. There may have been gifts in the years of purchase which would require some returns. In the example I assumed that there were no problems respecting delinquent gift tax liability.

Using trusts? Use caution

Let us devote some attention to trusts and practical uses for them in planning of estate affairs. They have advantages both for income tax and estate tax reduction. In the area of income tax, it is possible by the use of a trust or trusts to divide taxable income among members of a family group and even create taxpayers, that is, the trusts themselves. Also, the trust provides a mechanism for lessening the impact of death taxes by skipping over a generation in the ownership of corpus.

In order for a trust to serve tax-wise it must be irrevocable. That is, principal funds are tied up for years to be administered in accordance with a trust agreement which cannot be changed, while times and conditions do change. Of course, these agreements can be made flexible to a great extent, but I don't believe that anyone can foretell all of the things that might happen which would involve members of a family. Because of this, I have observed some hesitation on the part of some clients to accept the use of a trust in planning.

There are some uses of the trust which are more or less common and of real practical application in many estates. Quite often the portion of the estate which is not utilized for the marital deduction is placed in trust with the income to the surviving spouse and the remainder to the children. This enables the survivor to have all of the income from the entire estate but avoids the double impact of the estate tax. This could be used for the residue of John's estate after the maximum marital deduction. Also, we suggested that the wife's property pass to the children to avoid taxation in the husband's estate. If it is desirable that he have the use of income, a trust provides the means without the loss of the death tax advantage.

Let us go on to the subject of short-term trusts and to their use in a general plan of an estate. First we ought to define the term "short-term trust." What usually comes to mind is a trust reverting to the grantor in not less than ten years; it is irrevocable and the grantor does not retain powers over the corpus or income sufficient to cause the income to be taxed to him. Such a trust results in a temporary allocation of income away from the grantor. The income of the trust may be distributed to beneficiaries or retained by the trustee depending on the terms of the transfer. In either case it is likely that the tax reduction is attractive. The reduction, of course, is the result of using the low rates of the beneficiary or trust applied to trust income as compared with the higher rates of tax on the donor.

It seems to me that the short-term trust is over-advertised as a tax saving device. From time to time all of us have seen tax ads or letters distributed by tax book publishers and trust companies

Facts of Estate to be Planned

SUPPOSE THAT we have a family consisting of husband and wife, whom we will call John and Mary, and two children. There is a taxable estate to the husband in the amount of $750,000, of which $500,000 is owned in his own name. Life insurance payable to his wife is $100,000 and jointly owned property is $150,000. The wife and children have no property. The husband and wife have wills providing that each is the sole beneficiary of the other. We should first make a computation of the tax. For the purposes of this illustration, I have calculated the gross estate tax and have omitted state inheritance tax entirely. It is assumed that the property values given are after allowance for expenses of administration and debts.

If John were to die first, the tax on his estate would amount to $86,500. This is the tax on an estate of $375,000, one-half of the total estate, the other half passing tax-free. Mary's death would result in a tax of $181,925, making a total tax of $268,425. If Mary died first her estate would bear no tax. At John's death, the entire estate would be taxed; the amount of tax would be $212,200.

[*Paul F. Icerman is a CPA and member of the accounting firm of Icerman, Johnson & Hoffman in Ann Arbor, Mich.*]

which promise substantial tax reductions resulting from short-term trusts. I would guess that the small segment of the public that has heard of such things has the impression that the short-term trust is a slick gimmick which the rich use to beat the income tax. To me, its use as a device in estate planning is quite limited.

The usual illustration which accompanies the short-term trust advertising concerns the elderly aunt who is supported by a taxpayer at a cost of $3,000 per year. It is pointed out that the only tax benefit he receives is the exemption for a dependent which, if he is in the 65% rate, reduces his tax by $390. However, by creating a trust which will pay $3,000 of income to the aunt, he saves $1,950 in tax. It is further pointed out that if the aunt dies before the required ten-year period expires, the property may revert to the grantor without danger of nullifying the transfer. Auntie will have to pay tax on her $3,000 when it comes from the trust. This won't amount to much as she is probably over 65, has some medical expense deductions, and even she may be blind. Certainly, we can figure that there is going to be a net saving of around $1,500 per year. All this is true and the this particular taxpayer would reap handsome tax savings as a result of the trust. However, the advertiser usually tries to implant the idea that every taxpayer can enjoy such savings from the short-term trust.

Taxpayers who have substantial earned incomes with added amounts from investments are particularly attracted by this entrancing tale. Their nonearned income bears a heavy rate of tax. Quite often the nonearned income is not needed for current living expenses and is saved, thus being the means for estate accumulation. However, high income taxes seriously impede the rate of growth. Persons in this predicament look kindly on a tax saving scheme which can accelerate the growth of an estate for their children.

Let me tell you of an incident involving a taxpayer who established such a trust. He is a prosperous doctor of medicine who specializes in internal medicine. He has a wife and two children who are 14 and 11 years old. The family has never lived up all of their income, which has resulted in an accumulation of investments. Year before last he established a short-term trust providing that the income was to be accumulated for the benefit of his children. Shortly thereafter my friend came down with a mysterious ailment which appeared to be heart disease. Later this diagnosis was changed. Fortunately, he has recovered and is back at work.

The moral of my story is this. Persons who work for their living should not tie up major portions of their savings for periods of ten years or more. Here the objective was to increase the rate of accumulation for the children. It was done by risking the financial security of the grantors of the trust. This does not make good sense to me.

Now let us turn our attention to the fortunate person who is not dependent on his own efforts for his living. By setting aside a part of his property in a short-term trust the same kind of tax savings can be realized. But what about a reduction in the taxable estate? This the short-term trust fails to accomplish, as it is only a temporary assignment of corpus. It would be likely that a planner for the estate of a wealthy man would look for a trust which would accomplish a reduction in potential death taxes as well as income tax reduction.

No discussion of trusts for tax reduction should omit reference to two types which offer possibilities for substantial tax savings. These are multiple trusts and sprinkle (or spray) trusts. The multiple-trust scheme involves the creation of two or more trusts to accumulate income for the same beneficiary when one would serve all other purposes. These trusts have the advantage of low tax rates, as each is a separate taxpayer, and the use of multiple throwback exemptions of $2,000 each. You can see the tax avoidance possibilities in arrangements of this type.

I should warn you, however, to weigh carefully the changes of preventive legislation. Last May, the advisory group working on Sub-chapter J of the Internal Revenue Code recommended an amendment to Section 641 designed to deter tax avoidance in the area of multiple trusts. Others, including the American Institute of CPAs Committee on Federal Taxes, have indicated agreement with the objectives of this proposal.

The sprinkle trust involves vesting discretionary power in the trustee as to the distribution of income among beneficiaries. Usually, there also is the privilege of retention of income. Thus, the trustee may sprinkle the income among the beneficiaries for maximum tax advantage. Further advantage may be gained by retaining part of such income, this also at the discretion of the trustee. The fact that sprinkle trusts are being used to gain tax advantage is not unknown to Congress and others interested in tax legislation. So fas as I know, there have not been any specific proposals to prevent their use.

How to provide for a widow's disclaimer without risking gift tax

by **WILLIAM J. BOWE**

Often it is impossible to foresee at the time of drafting a will what will be the most desirable bequest to a surviving spouse, in terms of both her needs and resources, and the optimum tax arrangement. A solution that is being considered widely at present is the use of a bequest that will produce the maximum marital deduction with the expectation that the surviving spouse will disclaim all or part if that is prudent. Mr. Bowe discusses the gift tax hazard in disclaimers and suggests providing several real options for the widow's choice.

IN A VERY considerable number of cases it is impossible to foresee at the time a will is being drawn whether it will be advisable to provide for the marital deduction in full, in part, or not at all. The husband may have the bulk of the family wealth. His wife's assets may be nominal. She may, however, have prospects of inheriting a substantial estate from her parents. How much and whether it will come to her in the form of an outright bequest or be in trust for her for life may not be known. There may be an understandable reluctance on

her part and on the part of her husband to inquire. If, however, it should come to her in trust, then her husband's will obviously ought to provide for the full deduction. On the other hand, its use could be disastrous if the property were to come to her outright. Therefore, there is need for some plan to delay the time of the decision as long as possible.

In other cases, both of the spouses will have substantial holdings. Here it may be desired in both wills to utilize the marital deduction in whole or in part on the assumption that the surviving spouse is likely to outlive the first to die by several years, a fact more accurately determinable at the time of the first death than at the date of the drafting of the wills. In still other cases it may be difficult to anticipate what the likely estates of each spouse may be at the uncertain future date of the death of the first to die. Should the deduction be used in full, in part, or not at all in these cases?

To hedge against these uncertainties many lawyers, in drafting wills, have provided for a marital deduction bequest, in the maximum amount allowable, through a formula-type clause and then specifically authorized the surviving spouse to disclaim the bequest in whole or in part. Thus it was felt that a decision could be made by the wife and her advisers after the husband's death and at a time when most of the uncertainties would have been resolved. It was generally believed that a disclaimer or renunciation, in whole or part, did not involve gift tax consequences.

Proposed new gift tax regulations

The proposed gift tax Regulations make it clear that the Service will recognize that a complete renunciation of a bequest or inheritance will not incur gift tax, if, under local law, title to the property does not immediately vest in the legatee on the death of the decedent and if the disclaimer is made within a reasonable time after learning of the interest. Apparently the renunciation of a devise of real estate will be treated as a gift since title in most, if not all, jurisdictions passes directly to the devisee.

While the Service recognizes that a legatee may refuse to accept a bequest without having to pay a tax for the privilege, the Regulations hasten to add that a renunciation of only a part of the property may involve gift taxes. Thus, if a spouse is given a bequest of $100,000 with the residue going to her son, she may, without tax consequences, disclaim the entire bequest in favor of her son. But if she indicates a desire to take half and permit the other half to fall into the residue for him, she will be treated as having made a taxable gift of $50,000.

While there may be serious doubts as to the correctness of the Commissioner's position as to partial renunciations, the careful draftsman will attempt to achieve his objectives without incurring the risks of litigating this issue.

Multiple bequests

One device suggested has been to give the wife a number of separate bequests—in paragraph I a bequest of $20,000; in paragraph II, a bequest of an additional $20,000, etc., winding up with a formula-type bequest. Then if it appears desirable to use the deduction only in part, one, two, or more separate bequests may be renounced. Query: If these several bequests in form may not be treated as a single bequest in substance?

Perhaps a safer approach would be to make several specific bequests. Paragraph I might give her 200 shares of General Motors, with instructions to the executor that, if that number of shares is not owned by the estate, to purchase the same. Paragraph II might give her 100 AT&T, etc. The wife and her advisers may then promptly examine all the known facts and determine which bequests to disclaim in full. Again, query: If the mere form of putting the gift in several paragraphs will achieve the desired result? While separate gifts may be the answer, it strikes the writer that gifts in the alternative, with each bequest having some substantial economic equivalent to the other choices, will have a greater chance of success.

Alternative bequests

Assume a case where there is considerable doubt whether to use the marital deduction in full, to the extent of 75% or only 50%. The will may provide in the alternative for an outright bequest in an amount equal to 50% of the maximum allowable marital deduction, or for an amount in trust, with limited withdrawal privileges equal to 75% of the allowable deduction or an amount in trust equal to the maximum allowable marital deduction, with only a general testamentary power of appointment.

Here the choices represent substance rather than form. They may well involve questions other than tax considerations. Where the separate bequest plan is used, with several bequests of, say, $20,000 and even where the bequests are of different types of assets, the choice of the surviving spouse involves no selection between different gifts. She is, in renouncing any one or more bequests, taking less than all to which she is entitled. But where the gifts are in the alternative she is put to a choice. The taking of one deprives her of the others. She never had a right to more than one. It is doubtful that the Commissioner can treat her as having made a gift simply because she selects an alternative other than the largest dollar bequest.

Assume the maximum marital deduction to be $200,000. May not $100,000 in hand (the first alternative) be far more desirable to many spouses than the income from $200,000 for life, with only a testamentary power over the capital (the third alternative)? To others, after mature thought, the second alternative of income from $150,000, with withdrawal privileges of $10,000 a year plus the general testamentary power might prove the most attractive of the three.

There is judicial authority by way of dictum that would sustain this view. In the *Pierce* case, 146 F.2d 388 (2nd Cir. 1944), the decedent had an option under an insurance contract to take the face amount of the policy in a lump sum or to elect any one of the options. She elected to receive instalments over a specified number of years. The Commissioner took the position that she should be treated as though she had elected to take the cash and then had used it to purchase the instalments. In refusing to uphold this view, the court said: "It is a fiction to treat the situation as though she had made a bargain; it is as untrue as it would be to say that, if the policy permitted her to be paid in dollars or in pounds, she had bought the pounds from the insurer with the dollars. It is as untrue as it would be to say that, if a testator gives a legatee the choice of money or a chattel, and he takes the chattel, he has bought it of the executor."

Form of bequests in the alternative

The following is an example of alternative bequests: "(1) In the event my

[*William J. Bowe is Professor of Law at the University of Colorado. His article is reprinted from the December issue of Banking.*]

wife survives me she shall automatically become entitled to Bequest C, below, unless she shall elect within 120 days after the date of my death to receive instead Bequest A or Bequest B.

"(a) Bequest A. I direct my executor to set aside a portion of my estate equal in value to (i) 25% of the value of my adjusted gross estate (gross taxable estate less funeral and administration expenses and debts but before the deduction of estate and inheritance taxes) as finally determined for Federal estate tax purposes, less (ii) the value of all interests in property, if any, which pass or have passed to my wife under other items of this will or otherwise than under this will but only to the extent that such interests are for the purposes of the Federal estate tax law included in determining my gross taxable estate and allowed as a marital deduction. All values shall be those finally determined for Federal estate tax purposes.

"I give, devise, and bequeath the said portion to my wife absolutely and forever.

"(b) Bequest B. I direct my executor to set aside a portion of my estate equal in value to (i) 37½% of my adjusted gross estate, etc., (as in (a) above.)

"I give, devise and bequeath the said portion of my estate to my trustee, hereinafter named, IN TRUST NEVERTHELESS, to hold, manage, invest and reinvest, to collect the income and to pay over the income at least annually to my wife during her life. My trustee shall also pay over to my said wife such amount or amounts of principal as she may from time to time demand in writing delivered to the trustee, except such principal payments shall not in any one year exceed the sum of $10,000. Upon the death of my wife the trustee shall transfer any remaining principal of this trust to or for the benefit of any person or persons or the estate of my wife, in such amounts and proportions and in such lawful interests and estates, whether absolute or in trust, as she may appoint in her last will and testament, etc.

"(c) Bequest C. I direct my executor to set aside a portion of my estate equal in value to (i) one-half of my adjusted gross estate, etc., (as in (a) above).

"I give, devise and bequeath the said portion, etc., (as in (b) above except for the deletion of the sentence granting her the lifetime withdrawal privileges)."

New estate & gift decisions this month

Retroactive relief measure removes bar on refund clauses. Decedent died in 1937. In 1922, he had transferred property in trust, reserving the income for life as well as a reversionary interest conditioned upon his surviving two nieces. Because of this possibility of reverter, the Supreme Court held the value of the trust includible in his gross estate. Remedial legislation enacted in 1951 provided that for estates of persons dying in 1937 and 1938, the includibility of such trusts was to be determined by the provisions of the Regulations in force at the date of death of such persons. In reliance upon this retroactive tax relief measure, the executors of the estate seek recovery of the estate tax previously paid. The claim for refund was timely filed, despite the fact that many years had elapsed since the payment of the tax, since the remedial measure impliedly lifted the usual three-year bar on refund claims. Because the transfer would not have been includible under the Regulations in force on the date of decedent's death, the estate is entitled to recover the estate taxes paid. One judge dissents; he does not think the estate nontaxable under the Regulations in force at decedent's death. Nor would he interpret the remedial legislation as lifting the bar of the statute of limitations; in his view it applies only to cases open when it was adopted. *Field Estate (Hollander, Ex'r),* CA-2, 10/1/57.

THE ARTICLE "Preparing Form 1041: how income, deductions, distributions are reported," by William K. Stevens which appeared here last month was based on a speech written by him and published in the October, 1957, issue of the Illinois Bar Journal. It was used here with the kind permission of the copyright owner, the Illinois Bar Journal. The credit line was inadvertently omitted last month.

Bequests to bar associations not deductible as charitable. Bequests to the New York County Lawyers' Association, and the New York State and New York City Bar Associations do not qualify for the charitable deduction. These associations were organized and are operated to perform a variety of functions, only some of which might be properly designated as "charitable" within the meaning of the statute. Further, one of their purposes, law reform, would appear to involve influencing legislation, and deductions for this purpose are specifically prohibited by the Code. Certain other bequests, which failed and were subsequently allocated by the executors to Columbia University, were also denied qualification. Although they went in fact to an admitted charity, the executors had had discretion to allocate them to noncharitable legatees, this power of diversion being sufficient to disqualify them. On the other hand, a gift to a foundation created to promote education qualified for the deduction. Although the expressed purposes of the foundation did not leave its charitable nature free from doubt, the fact that its expenditures up to the date of the gift had been for education solely was determinative of its charitable nature. The Commissioner's method of computing the amount of the charitable deduction, including in the taxable estate that portion of the charitable bequests used to pay estate taxes, is upheld by the court. *Cromwell Estate (Dulles Ex'r),* DC N. Y., 9/30/57.

Fees paid attorneys of legatees deductible. In the same case which passed upon the deductibility of bequests to bar associations, certain legatees had incurred legal expenses in defending their interests. The Surrogate's Court had approved payment of the fees by the estate. The Commissioner contended that, being attributable to the representation of the interests of individual legatees, they were not deductible. The court holds that the Surrogate's Court would not have permitted an allowance to be made had the attorneys' services not benefitted the estate, and that consequently the expense is deductible. *Cromwell Estate (Dulles, Ex'r),* DC N. Y., 9/30/57.

Insurance includible; decedent paid premiums (Old Law). Decedent's wife took out three life insurance policies on the life of the decedent, naming herself as owner and primary beneficiary. All premium payments were made by checks drawn on the wife's bank account. Over 95% of the deposits to the wife's account, however, had their source in checks drawn on the decedent's personal checking account. Since it was the de-

cedent who was thus indirectly paying the premiums, the insurance proceeds were includible in the decedent's gross estate. *Loeb Estate,* 29 TC No. 4.

Decedent must be buried in plot before deduction for its perpetual care allowed. Amounts expended pursuant to a decedent's will for the perpetual care of a family burial lot in which the decedent is interred, including all the graves in the lot, are deductible from the decedent's gross estate as a funeral expense. However, if the decedent is not himself to be interred in the lot, the deduction is not available. In that situation, the expense is not a funeral expense. *Rev. Rul.* 57-530.

Estate includes joint property transferred; income was retained. Decedent purchased property with his separate funds and took title in the names of himself and his wife as tenants by the entirety. Later, they transferred the property in trust to pay the income to themselves in equal shares during their joint lives, with the entire income to the survivor for life. The decedent was survived by his wife. The value of the trust property, less the value of the life estate of his wife in one-half thereof, is includible in his gross estate as a transfer under which he retained the right to receive the income for his life. *Rev. Rul.* 57-448.

Civil service death benefit fully includible in gross estate despite community. State community property laws do not apply to annuities, death benefits, or refunds payable under the Civil Service Retirement Act, since such application would conflict with the provisions of the Federal statute. Consequently, the full value of retirement contributions is includible in the gross estate of a Federal civil service employee resident in a community property state. *Rev. Rul.* 57-446.

State law determines tax payable from marital share; commuted power not a terminable interest. The widow of decedent elected to take under the provisions of Missouri law rather than under the decedent's will and, as a result, received one-half of his personal property as well as the cash value of her dower and homestead interests. In all, her share amounted to 37.13% of the gross estate. It was by the latter percentage of the Federal estate tax that the marital deduction was to be reduced, not, as the Commissioner contended, by one-half of such estate tax. The law of Missouri does not require that the entire Federal estate tax be paid out of the personal property, but equitably apportions the burden. Nor is the commuted value of the dower and homestead rights merely the proceeds of the conversion of a terminable interest, but rather it is an absolute right to a cash sum distinct from statutory dower and homestead. *Miller Estate, (Traders National Bank, Ex'r),* CA-8, 10/18/57.

Lack of testamentary power of disposition fatal to marital deduction. [*Certiorari denied*]. Decedent's widow was bequeathed a legal life estate coupled with an absolute power of disposition over the remainder. There was a gift over of any principal undisposed of at her death. The bequest does not qualify for the marital deduction. Even assuming that the bequest might be regarded as creating a trust, and the widow had an unlimited power to dispose of the corpus by inter vivos gift, the widow's lack of control over the disposition of the property upon her death was fatal to qualification. The fact that the property undisposed of might be includible in her gross estate at her death was not determinative. *Pipe Estate, cert. den.* 10/14/57.

Power to divert income disqualifies marital deduction trust. Decedent's will created a trust under which his widow was to receive the income for life with a general power of appointment over the remainder. Her income interest was qualified, however, in that the trustee had the power to divert to decedent's sons so much of the income as might, together with other income available to them, prove necessary for their maintenance and education. Although the sons had an independent income, and the possibility of diversion of income from the widow was remote, the trust nonetheless did not qualify for the marital deduction; a mere possibility of diversion is sufficient to disqualify an otherwise eligible disposition. *Weisberger Estate, (Thomas, Ex'r),* 29 TC No. 26, 11/14/57.

Registered owner of "E" bonds conclusively presumed true owner. The decedent during his lifetime purchased Series "E" bonds and had them registered in the joint names of himself and various other persons. He later made a gift of the bonds to the other joint owner in each case. The bonds are nevertheless includible in his gross estate. The form of registration of the bonds creates a conclusive presumption as to their ownership. The purchaser has a certain interest in the bonds, determined by the form of registration, of which he cannot divest himself, at least in any litigation in which the Government is involved. For taxing purposes, as well as for cashing purposes, the registered owners are conclusively presumed to be the real owners, and any evidence to the contrary is inadmissible. *Silverman Estate* DC Pa., 8/26/57.

Liquidation value of corporate assets does not fix value of minority interest. Stock which was only 2% of the outstanding shares of a family holding company is valued by the court for gift tax purposes at $130 a share, representing a 20% discount from the net value of the company's underlying assets, a securities portfolio. There had been no prior outside sales of the stock. A majority position in the stock, or even a larger proportionate holding than that involved, might justify a value approaching liquidation value, but so marked a minority position in a closely held corporation would cause potential buyers to seek a substantial discount from liquidation values. *Bartram,* DC Conn., 9/26/57.

Enforced transfer not a gift. An Osage Indian princess applied to the Bureau of Indian Affairs for a certificate of competency which would free her from certain restrictions placed by the Federal Government upon her power to deal with her own estate. The granting of the certificate was conditioned upon her setting up an irrevocable trust for her children, thus protecting them from possible dissipation of the estate. The princess resisted but, after long negotiations, a figure lower than that originally set by the bureau was agreed upon and the trust created. The transfer by the princess is not subject to the gift tax. The entire transaction was more in the nature of an arm's length business bargain than a gift, and was completely free from any donative intent. *Shelton,* DC Mo., 8/29/57.

Notes on new estate and gift decisions in this department are by Edward P. Hannigan, member of the New Jersey Bar and associated with Harrison F. Durand in Newark.

TAX CONSEQUENCES OF

Corporate organization and distributions

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA
and RICHARD L. GREENE, LL.B.

Methods of utilizing loss carryovers: safe, doubtful and forbidden

by **JAMES A. CUDDIHY**

The loss carryover area of the Code has been difficult at best; recent decisions raise new doubts and questions. In this article, which is an expansion of the tax section of a paper on corporate acquisitions presented at the Twelfth Annual Conference of the Tax Executives Institute, Mr. Cuddihy reviews the various methods for using a loss and comments on the recent disturbing cases.

A CORPORATION with a loss carryover has unique and varied means of leaving the red for the black, always assuming, of course, that it is not hopelessly insolvent. Most of the leading banking institutions are keenly aware of taxes and the utilization of loss carryovers and will take full cognizance of them in making loans. The SEC likewise is aware that a loss carryover may be a valuable asset and will request tax opinions as to the availability of a loss carryover in the filing of registration statements. Numerous business failures in the past few years could have been avoided by the diligent and skillful use of the loss carryover. Of course, in today's highly competitive market and tight money situation, the horizons are not as wide as during the past five years or so. However, its usefulness as a real business asset is limited only by the imagination, resourcefulness, skills, techniques and boldness of a company's management and tax advisors.

There has never been any serious doubt that a corporation with a loss carryover might use its own loss carryover against its own profits in future years (under the 1954 Code, for five future years, as well as the year at issue and a two-year carryback). In a recent case, however, (*Olivier Company*, 57-2 USTC Par. 9723 (DC Ala.), on appeal by the taxpayer, it was held that the taxpayer-corporation could not carry forward its net operating loss and offset it against the income of a subsidiary earned after the date of affiliation. The case thus involved acquisition of a profitable corporation by a loss corporation and resulted in disallowance of preaffiliation loss, in a consolidated return, against postaffiliation income. Although the case was decided under the prior Code and Regulations, the new Code and Regulations are unchanged. It is interesting to speculate whether the court would have arrived at a different decision had the loss corporation purchased assets and filed a simple return rather than a consolidated return. It is difficult to see the reason for the harsh regulation and the, in effect, additional penalty for filing a consolidated return. On appeal, the taxpayer has questioned the validity of the regulation upon which the decision was based.

The taxpayer has argued that a regulation section which divides a taxable year into "portions" for purposes of computing income or losses does illegal violence to the principle of annual accounting and is invalid.

In *Hughes Tool Company*, decided by the Fifth Circuit in 1951 (118 F.2d 474), the court concluded that the 1928 Act did not authorize an article of the consolidated returns regulations which would divide the taxable year of a corporation entering into an affiliated group into "portions" so as to prevent the offsetting of the income of the group in the year of affiliation by the loss of the subsidiary incurred during that year prior to affiliation. The court re-emphasized the continuing integrity of the concept of the "full accounting year" which survives even the Commissioner's power to regulate consolidated returns. It stated in part:

". . . the provisions for carryover loss deductions in Section 117(b) from consolidated income of the succeeding year means the full accounting year, and not merely a portion thereof. The Regulation promulgated by the Commissioner under the law of 1928, which provides that any period of less than 12 months, for which either a separate or a consolidated return is filed, shall be considered a taxable year, is inconsistent with the statute and must fail of force and effect."

Although profit-making companies may sometimes be acquired to use up losses, there are many other methods available to a loss company that are particularly desirable in the last years of an expiring carryover, to utilize the loss; for example, precipitation of rental income, purchase of installment obligations, postponement of transactions which involve accrual of interest, postponement of wage increases and outlays for new buildings and plants, reduction of advertising expenses and contributions, etc., until the carryover expires.

Section 269

The famous or infamous *in terrorem* section of the Code, Section 269 and its predecessor, Section 129, since the days of the *Alprosa Watch Corporation* case,[1] has been constantly held, until recently, by the courts to have no applicability to a corporation which has a loss and endeavors to improve its position by adding profitable assets to its structure. As late as February, 1957, in the *T. V. D. Company* case,[2] the Tax Court stated, "It is manifest from the unambiguous terms of Section 129 that it applies only to an acquiring corporation and does not apply to an acquired corporation." It is interesting to note that the Commissioner has decided not to appeal from the Tax Court decision. The Tax Court took a similar position in

the *Coastal Oil Storage Company* case, but was reversed by the Court of Appeals for the Fourth Circuit.[3] In this case, the taxpayer had been created to receive storage tanks of its parent not used in the parent's Government work. The Fourth Circuit Court stated, in part, in ignoring the corporate existence of the subsidiary:

"It is clear that the parent corporation acquired complete control of taxpayer through stock ownership and the parent corporation was certainly a person within the meaning of subsection (1) of the statute. As a result of the transfer of its property in exchange for the stock, it was able to obtain through this splitting up of its corporate business the benefit of an exemption and credit which it would not otherwise have enjoyed."

Therefore, although the subsidiary claimed the exemption, the court felt the parent obtained the benefit and that Section 129 applied. It is submitted that the court's reasoning was strained and unsound. Sections 129 and 269 refer to persons who "acquire" control. They do not say "form or acquire." It is to be expected that cases will arise in other circuits, and, ultimately, the problem may be one for the Supreme Court.

Illogical presumption in Section 269

Section 269 remains the same as old Section 129, with one exception. A dubious, in fact, illogical, presumption has been added, that is, that the principal purpose of the acquisition is evasion or avoidance of income taxes when the consideration paid is substantially disproportionate to (less than) the sum of (1) the adjusted basis of the property acquired and (2) the tax benefits not available otherwise than as a result of the acquisition.

This presumption will probably be disregarded by the courts since:

1. The facts which cause it to arise are usually not probative of the principal purpose. Appreciation or depreciation in the value of the property involved will often make the presence or absence of the presumption fortuitous; for example, if the property has appreciated above its depreciable basis by an amount equal to the tax benefits involved, the acquirer will reasonably pay such a consideration and will prevent the presumption from arising.

2. The amount of tax benefits may be impossible to measure.

3. The beneficial tax attributes are treated as an asset, the value of which can be measured in dollars and cents and compared with the consideration paid by the purchaser. In other words, the prospective buyer is told he may sell the attributes, but the purchaser is cautioned not to make too good a purchase.

4. There is ordinarily no real relation between the basis of the corporate assets and the price paid for the stock. The price is much more likely to be related to net asset value. If we assume a corporation with an asset basis of $100 but a value of $50, a purchase price for $50 is less likely to be motivated by tax purposes than a purchase in excess of value (which might be motivated by the depreciation allowances). Thus, if the purchaser has no thought of the tax advantages, he may encounter the Section 269 presumption by having failed to take it into account. Ironically enough, then, it may be easier to overcome the prima facie evidence of disproportionate purchase price, the more disproportionate the price may be. It would seem as if the courts will, therefore, be forced to ignore this presumption.

Purchase of loss corporation stock

Two new sections of the 1954 Code, Sections 381 and 382, attempt to supplement Section 269. Under these sections the acquisition of assets of a subsidiary in a tax-free liquidation will result in the inheritance of 19 specific tax attributes of the subsidiary, including the net operating and capital loss carryovers. However, it is also possible to inherit certain undesirable tax attributes, unless careful planning is used. Note that if the tax-free liquidation is one under Section 334(b)(2) (liquidation following acquisition), there is no inheritance of the tax attributes of the subsidiary.

It is important to note that unless the date of completion of a distribution or transfer is properly chosen, the period during which losses of the distributor or transferor corporation may be carried forward may be shortened by as much as 23 months. This follows from the rule that a "past year" of the acquiring corporation beginning on that date is counted as one of the first years to which a loss may be carried forward.

To be brief, if stock of a loss corporation is purchased, then under Section 382(a) the entire operating loss will be lost if 50% or more of the loss company's shares are purchased and thereafter the business is changed. A change occurs[4] when there is: (1) Shift from one location to another; (2) Change in location; (3) Contraction of business.

The Senate reports, above, somewhat unreasonably indicate that the rules should be strictly construed. However, it appears inevitable that litigation will result in an effort to clarify the vagueness of the "change" test.

It should finally be pointed out that the wording of Section 382(a) leaves little doubt but that if the corporation was dormant before acquisition, the acquiring corporation cannot utilize its losses.

Under Section 382(b) a partial disallowance of the loss will result, to the extent that in an acquisition by certain reorganizations, the shareholders of the loss company receive less than 20% of the outstanding stock of the acquiring corporation (could be preferred voting stock). However, the court-made rules to determine business purpose for a valid reorganization will be applicable, so that although, on the surface, a transaction may meet the requisites of Section 382(b), a closer examination may disclose no genuine business purpose and, thus, no reorganization.

Might bonds or nonvoting preferred stock be converted into eligible stock in order to satisfy the 20% test, or may there be an additional contribution of capital by the loss corporation stockholders when the other corporation, as a practical matter, is too large to give up the 20% necessary? These are interesting questions which conceivably would be answered by application of the business-purpose or step-transaction rules.

American Pipe & Steel

In the *American Pipe and Steel* case,[5] in which certiorari has recently been denied by the Supreme Court of the United States, the taxpayer-corporation was in the steel fabricating business. It acquired the stock of a dormant real estate corporation with a high basis loss value property. After acquisition, the properties were sold at a loss and the losses offset against the taxpayer-corporation's profits in a consolidated return. The Commissioner's attack under

[1] 11 TC 240 (1948).
[2] 27 TC 108 (1957).
[3] 242 F.2d 396 (4th Cir. 1956), rev'g 25 TC 1304.
[4] See S. Rept. 1622, 83rd Cong., 2d Sess., p. 228 (1954).
[5] 243 F.2d 125 (9th Cir.).
[6] 77 Sp. Ct. 990.

[*James A. Cuddihy, member of the New York bar, is Tax Counsel with Chesapeake Industries, Inc., New York.*]

Section 129 was successful. The court was obviously influenced by the fact that the loss corporation stock cost only $11,000 while the tax losses were in excess of $400,000. The court, likewise, despite herculean efforts of the corporation and its counsel, could find no business purpose in the acquisition. The case marked a milestone in the Government's attack on acquisition of loss corporations, as its first Section 129 victory.

Libson Shops

In the *Libson Shops* case,[6] 16 separate retail corporations, all owned by the same interests, were merged into Libson Shops Management Corporation, a separate corporation that provided management services for retail apparel shops. Three of the retail corporations had accrued losses of approximately $22,000 prior to the merger.

The Government argued that (1) the loss should only be allowed to the corporation actually sustaining it and (2) the carryover was not available unless there was a continuity of business enterprise. The Supreme Court refused to rule on the first issue but decided for the Government on the second, that is, there was no continuity of business enterprise.

The Court also specifically found that Section 129(a) was inapplicable, since there was no acquisition of corporate property for the principal purpose of tax evasion. In addition, the Court said in footnote 9:

"We do not pass on situations like those presented in *Northway Securities Co.*, 23 BTA 532; *Alprosa Watch Corp.* 11 TC 240; *A. B. & Container Corp.*, 14 TC, 842; *WAGE, Inc.* 19 TC 249. In these cases, a single corporate taxpayer changed the character of its business and the taxable income of one of its enterprises was reduced by the deductions or credits of another."

Thus, the Supreme Court disallows a loss carryover where 16 corporations carrying on a retail business and owned by the same interests merge, at the same time distinguishing it from a case such as *Alprosa Watch Corporation,* wherein a group acquired the stock of a glove company with an operating loss and used the corporate loss against profits from the sale of watches (having sold all of the glove business assets back to its former stockholders).

The sole, narrow grounds of distinction seem to be that the Court found there were 16 separate, distinct businesses (although in exactly the same business with exactly the same ownership), the sole difference being one of location, together with the fact that had there been no merger, a tax benefit for the year under consideration would not have been available. It would seem that if each of the three loss corporations had acquired the assets of one of the profitable corporations, there would have been no difficulty in using the losses, nor would there have been difficulty if there had been one corporation with 15 divisions or if it had been possible to file a consolidated return.

It would be carefully noted that the Commissioner continues to argue that statutory privilege of a carryover is not available unless the corporation claiming it is the same taxable entity as that which sustained the loss. This despite the Supreme Court case of *Metropolitan Edison Company,* 306 U.S. 522, which held that a corporation resulting from a statutory merger is treated as the same taxable entity as its constituents to whose legal attributes it has succeeded by operation of state law.

Supreme Court rationale

The unfortunate reasoning of the Supreme Court in this case may be illustrated by the following:

1. After admitting that there is little history to uphold its finding that Congress primarily was concerned with a single business, the Court points to a 1939 House Ways and Means Report as its sole authority. A careful reading of the portion of the report set forth lends itself to no such conclusion.

2. In speaking of a change of trade or business, the Court refers to Section 382(a) of the 1954 Code which is concerned with a purchase of a corporation. The correct section, involving statutory mergers, is Section 382(b), wherein there is no such requirement of continuing the same trade or business other than that which may be necessary to establish the fact that there was a valid reorganization.

3. The Court implies that the problem could have been avoided if a consolidated return had been filed. This is an erroneous implication since a consolidated return could never have been filed as there was no parent corporation but rather seventeen different corporations, the stock of which was owned by individuals in the same proportions.

The pertinent question, of course, in view of this poor decision, is whether *Libson Shops* will apply to transactions covered by the 1954 Code. In the opinion of the author, it will not have applicability. Section 382(b)(3) states that the limitations in 382(b) will not apply if the transferor corporation and the acquiring corporation are owned substantially by the same persons in the same proportions. Of course, the argument will be made that Section 382 is a rule for disallowance of losses and indicates under what special circumstances losses will be disallowed but that it does not mean that under all other circumstances losses will be allowed. For example, a case under 269.

Ratio to taxable income

However, Section 381(c)(1)(B) relates the deductions attributable to the loss carryovers of the distributor or transferor corporation to the acquiring corporation on the basis of certain ratios "to the taxable income . . . of the acquiring corporation." Therefore, the section would seem to mean that the carryover is related to the taxable income in the "acquiring corporation" without fragmentation within the corporate framework of the merged company as in *Libson Shops.*

The decision of the Supreme Court resolves itself into a question of form rather than substance or, if not that, is simply a new Supreme Court rule much like the "business purpose" rule. It is a regrettable decision and one which will serve to muddy the already cloudy waters of the loss carryover field. It is devoutly to be desired that the case will be limited strictly to its facts and applied only under the 1939 Code, but there are indications that the Government may use it as carte blanche to attempt to strike down all types of acquired corporate loss carryovers.

Sections 382, 381, 269 and, to a lesser extent, 482 (Section 45 of the 1939 Code, permitting allocation of income and deductions among taxpayers), present a bewildering pattern of different penalties, business purposes, percentages of control, etc. It will only be by the most careful and painstaking analysis, and advice by competent tax advisers, that the loss carryover myster-

ies can successfully be solved and used. In addition, since the Commissioner has been recently successful in several loss carryover cases, we may anticipate more and more litigation in all of the courts. ☆

Current tax trends in corporate capitalizations and recapitalizations

by RICHARD L. GREENE *and* JOHN L. PALMER

SOME CURRENTLY popular methods of financing development and expansion may create interesting tax problems, particularly when applied to closely held corporations. In this discussion of certain rulings and other recent developments there will appear a rather definite pattern of placing publicly held corporations beyond many of the restrictions that inhibit the capitalizing and recapitalizing desires of the closely held companies.

At this point we hasten to mention that we will concentrate here on recent trends and developments in the capitalization and recapitalization arena. This will not be a primer on Sections 306, 351 and 368, all of which has been explained and exposed on many occasions and in many publications. We are certain that the fundamentals are so well known that any reference to them will be avoided whenever possible.

In our own meanderings through the tax services and publications and in our function as editor of this section of THE JOURNAL OF TAXATION, we have found the most intriguing tax questions during the past year or two have arisen in connection with preferred stock issues, or nonvoting stock, or stock-dividend type stock, and with stock warrants. Probably the one that has occasioned the most rulings is preferred stock, and hence we will first focus on that form of capitalization.

Preferred stock still useful

When Section 306 first appeared in the 1954 Code, tax men generally feared it spelled the death of the once-popular preferred stock issues. Preferred stock issued thereafter, whether in a recapitalization or by way of a stock dividend, became known as "tainted stock," as if it were a poisonous food or wine that had turned sour. The "taint" or "curse" of Section 306 stock was the treatment generally of proceeds from its sale as ordinary income and its redemption as a dividend. Experience plus a flow of favorable rulings during the past two years has proven, however, that preferred can still be very useful and that it is quite possible to remove the "curse" or escape the "taint" of Section 306.

Preferred issued at incorporation

Most of the tax questions and rulings relating to preferred stock involve preferred issued in a recapitalization or as a stock dividend. Before noting these, we should remember that if the preferred stock is issued at the time of incorporation before the corporation has any earnings, it will escape the impact of Section 306[1]. Thus, even though there may seem to be no immediate need for it, if there is a possibility that preferred may be issued later on, some thought should be given to its original issuance. It may later prove useful in connection with estate planning, income minimization by gifts, compensation of key employees, etc.; and by issuing it when there are no earnings, troublesome Section 306 problems may be obviated.

Preferred in merger or reorganization

One of the first rulings construing Section 306 in connection with a reorganization is *Rev. Rul.* 56-116.[2] Unfortunately, a careful reading of the language gives rise to considerable apprehension in place of the first impression that the ruling is completely favorable. In a statutory merger of two corporations, shares of common and preferred stock in the surviving corporation were transferred in exchange for common stock in the merged corporation. Both corporations were publicly held. The reason for the transfer of some preferred to the merged corporation's shareholders was to limit their share in the expected future equity growth of the surviving corporation and to prevent greater dilution of the voting power of the pre-merger shareholders in the continuing corporation. It was further established that the management of the surviving corporation had no intention of redeeming any of the preferred which was issued in the merger except as required under the provisions of the purchase fund and sinking fund provisions. These provisions were not incorporated in the ruling.

Citing Subsection 306(b)(4)(A) which avoids 306 treatment if the *distribution* and *disposition* "are not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax," the Treasury ruled that *disposition* of the preferred will not be subject to 306 treatment "unless such disposition is in anticipation of a redemption after the issuance of the stock."

By inference, (a) redemption of the preferred requires 306 treatment, and (b) any other sale in anticipation of redemption requires 306 treatment.

Thus, the apparent relief accorded by the ruling is minor. Particularly disturbing is the implication that any redemption is pursuant to a plan to avoid income tax.

In another situation an apparently contrary, and certainly more liberal result obtained where preferred was received in a "C" reorganization. (*Rev. Rul.* 57-103).[3] In this case the preferred was held not to be 306 stock because it was not issued pursuant to a plan having as one of its principal purposes the avoidance of income tax.

The only distinguishing fact between this ruling and *Rev. Rul.* 56-116 was that in the earlier ruling the preferred was issued to prevent the shareholders of the transferor corporation from sharing in the equity growth of the surviving corporation. This seems to be a distinction without any significance and it is hoped that it eliminates, as a matter of policy, the restrictions placed upon disposition by the earlier ruling, which is simply cited at the end of this ruling.

Another ruling in the same area is *Rev. Rul.* 56-223.[4] Pursuant to a recapitalization designed to lower the price of voting common to enable employees to purchase it, M corporation issued three shares of common and one share of preferred for each old share of common. About 80% of the company's stock was owned by employees and the company's profit-sharing trust also was a shareholder.

Prior to the recapitalization, the

[1] Sec. 306(c)(2).
[2] Rev. Rul. 56-116, IRB 1956-13, 6.
[3] Rev. Rul. 57-103, IRB 1957-11, 9.
[4] Rev. Rul. 56-223, IRB 1956-21, 8.
[5] Rev. Rul. 57-328, IRB 1957-28, 9.
[6] Chamberlin, 207 F.2d 462 (CA-6 1953).
[7] Elmer W. Hartzell (1939) 40 BTA 492.

[*The authors are partners in the Milwaukee law firm of Whyte, Hirschboeck, Minahan, Harding & Harland. This article is based on a paper presented at the Marquette Tax Institute in October.*]

profit-sharing trust had agreed to purchase almost half of the outstanding stock from retiring employees over a six-year period in order to prevent that stock from being sold to another corporation which was interested in buying it so as to acquire a substantial interest in M Corporation. When the recapitalization was effected the new stock was automatically subject to the same agreement.

Recognizing that the recapitalization and sale of the preferred were not pursuant to a plan to avoid income taxes, the ruling held that the sale of the preferred will be a capital gain transaction, the preferred not being subject to 306 treatment.

Contributions of preferred

Another prime usage of preferred stock is as a vehicle for charitable contributions. If this gift of preferred can eliminate the taint of Section 306, the donor can retain his control and secure without cost to him not only a valuable charitable deduction for income tax purposes, but also a significant minimization of his estate taxes. Suppose our generous common stockholder first arranges for the issuance of preferred stock by way of a nontaxable stock dividend or by a recapitalization (the dividend route is safer since it probably eliminates the need of a business purpose). Thereafter he gives the preferred stock to his favorite charity—probably over a period of years so as to secure the maximum charitable deduction each year. At the same time he has parted with no voting control and has cut down on his estate taxes because the value of his common is diluted and reduced.

Rev. Rul. 57-328[5] approved this type of arrangement in July of 1957, and held that even though the preferred was Section 306 stock, the disposition did not result in any income to the donor. Moreover, the subsequent sale by the foundation of the donated preferred did not result in the realization of any income by the donor. The ruling did stress that there was "no pre-arrangement" for the sale by the foundation. *Cf. Chamberlin.*[6]

We find with growing satisfaction that the Service now recognizes the business realities of a recapitalization where younger key executives receive voting control and the older or retiring executives receive dividend-paying preferred. The Tax Court had previously sustained the tax-free effect of this type of recapitalization, approving the business importance of shifting control of the voting common stock to aggressive management by having the older or inactive stockholders exchange their common for a dividend paying preferred stock. These were the *Hartzel*[7] and *Dean*[8] cases.

Dean and Hartzel had to litigate to establish this tax-free recapitalization of preferred for common. Now, however, the Service has in two more recent published rulings approved the same type of transaction. In *Rev. Rul.* 55-112,[9] three retiring shareholders received preferred for common in a recapitalization which left control in the other two common shareholders. So also in *Rev. Rul.* 54-13,[10] there was a nontaxable recapitalization by an exchange of preferred to an older stockholder in order to accomplish an increase in the common stock interest of a younger key executive. His management and ability were responsible for the growth of the company and he was dissatisfied with his smaller stock interest.

These rulings and decisions involved only the tax-free effect of the exchange of the preferred for common stock, and did not consider the potentially delightful dilemma as to Section 306. What happens if the older stockholders later redeem the preferred stock they received in the recapitalization? Presumably it qualifies as Section 306 stock if there was sufficient earned surplus when the exchange was made, but still it is possible to escape the "taint" under Section 306(b)(4), if it can be shown there was not an intention of redeeming it at the time of recapitalization. See *Rev. Rul.* 56-116,[11] which stressed this "pure intention," even though there was a provision for redemption under a sinking fund agreement.

Redemption of preferred and 302

The importance of establishing a business purpose so as to make a redemption of non-306 preferred not "essentially equivalent" to a dividend is strikingly illustrated by *Rev. Rul.* 56-485.[12]

In this situation the corporation had outstanding some 8% cumulative preferred which was issued 30 years ago and on which no dividends had ever been paid. By 1956, the accumulated and unpaid dividends totalled 600x dollars and the corporate surplus amounted to 610x dollars. The corporation desired to eliminate as much of this preferred as possible because of its high dividend rate. Therefore, it redeemed 20% of the preferred at 30x dollars per share (including 20x dollars of accumulated dividends).

Because no one person or family group owned over 25% of the voting stock and the preferred was generally held in different proportions, the redemption was held not essentially equivalent to a dividend.

An opposite conclusion was reached in *Rev. Rul.* 56-521,[13] where all of the common stock was owned by one shareholder and the preferred was divided among him, his sister and brother. In that case the redemption of all of the preferred was held essentially equivalent to a dividend to the remaining sole common shareholder. The ground was that the redemption did not increase or decrease his control or equity in the corporation and the net effect was simply to distribute corporate earnings and profits to him. This ruling is similar to one the writers received in 1955, which involved preferred purchased for cash and redemption was advisable so as to eliminate a high dividend preferred which was a drain on the corporate earnings.

Surprisingly enough, however, in *Rev. Rul.* 55-462,[14] the Service accorded capital gain treatment to a redemption of preferred which equalized the preferred stockholdings of two shareholders pursuant to their earlier agreement that they would invest equally in preferred. The shareholders were unrelated and each owned 50% of the common. Some time ago, one shareholder purchased 15 shares of preferred and the other purchased one share but promised to buy an additional 14. When he found himself unable to do so due to personal finances, the corporation redeemed 14 shares from the other shareholder. The corporation had always paid sizeable dividends but still had an earned surplus. Primarily because of the prior agreement and the fact that the distribution was not pro rata, the redemption was granted capital gain treatment.

Before departing from the woods of Section 306 and its many uncharted bypaths, we found a recent warning from Service that even common stock can

[8] Marjorie N. Dean (1948) 10 TC 19.
[9] Rev. Rul. 55-112, 1955-1 CB 344.
[10] Rev. Rul. 54-13, 1954-1 CB 109.
[11] Rev. Rul. 56-116, IRB 1956-13, 6.
[12] Rev. Rul. 56-485, IRB 1956-40, 10.
[13] Rev. Rul. 56-521, IRB 1956-43, 11.
[14] Rev. Rul. 55-462, 1955-2 CB 221.

readily fall into the Section 306 trap. *Rev. Rul.* 57-132,[15] gave us a timely warning last April that nonvoting common can be Section 306 stock. The stock involved in the recapitalization was identical in all respects to the voting common stock, except as to the absence of the right to vote plus the vital difference that it was redeemable at the discretion of the corporation at 110% of book value.

The redemption feature, of course, made the nonvoting common more like preferred and hence brought it under the Section 306 taint. There are other situations covered in the Regulations (Section 1.306-3(e)) where common may be construed as Section 306 stock, and these should be scrutinized before any recapitalization or tax-free dividend is contemplated.

Unplanned recapitalizations

Frequently even in our tax-conscious world businessmen proceed with what seems to be a sensible course of operations without realizing the tax effect of their actions. *Rev. Rul.* 56-654[16] is a timely reminder that a corporation may have a recapitalization without even planning it or realizing it. The corporation merely amended its articles of incorporation to increase the redemption or liquidation value of the preferred stock. This reduced the value of the common stock so as to permit an officer to buy 10% of the common stock at a price he could afford to pay and kept him from sharing in the prior earned surplus.

Even though there were no new shares of stock issued and no physical exchange, this simple amendment was ruled to be a recapitalization. It was fortunate that the taxpayer in *Rev. Rul.* 56-654 received a tax-free ruling. Other taxpayers in an unplanned and unintended recapitalization may not be so fortunate. Thus, cautious tax planning is indicated wherever the management contemplates an amendment to the articles affecting the capital stock.

Once in a while a recapitalization may be intended and planned but poorly planned. What was assumed to be a tax-free exchange may end up as a taxable dividend with a disastrous tax bill. One more taxpayer made this sad discovery recently. Carl A. Ortmayer[17] found that his recapitalization exchange of common stock for debentures (part of which was turned in to cancel a debt) was construed as a taxable dividend. Most taxpayers prefer to forestall the disastrous effect of a collapsed recapitalization by securing an advance ruling from the Service.

Thin incorporation trends

One of the chronic problems of capitalizations either initially or at a later stage of corporate life, particularly where the company is closely held, is whether shareholder funds can be loaned to the corporation for notes or debentures, as contrasted to money paid for stock. The tax advantages of such loans are vast, but so apparently are the risks, as indicated by constant litigation on the point.

Tax men, by now accustomed to novel Tax Court approaches to apparently well-settled problems, were somewhat vexed when *Gooding Amusement Co.*[18] case introduced a new test to the thin incorporation problem. Many were astounded when the Sixth Circuit affirmed.

Prior decisions had turned on the form of the obligations and the ratio of debt to capital stock. Although the prior tests were somewhat difficult to apply in practice, it was fairly generally agreed that any ratio in excess of four to one was potentially dangerous, even assuming that the customary precautions were taken in evidencing the debt.

However, the *Gooding* case may very well mark the first nail in the coffin of the debt-ratio test. In *Gooding* the ratio was approximately one to one if fair market values of the underlying assets were considered. The original five-year notes totalled $232,000 and although the stock had a stated value of only $49,000, the fair market value based on values of the underlying assets was approximately $230,000 also. In order to purchase new equipment the corporation later borrowed another $570,000, only about $160,000 of which was loaned by the shareholders, the balance of $410,000 coming from commercial lenders. Because of this substantial indebtedness the corporation repaid only a portion of the notes ($75,000 of $232,000) to the shareholders and all of the notes were overdue. With the exception of one year, interest payments were made when due.

Although there was no subordination agreement, the court found as a fact that the shareholders had subordinated their claims to those of the other creditors and held that the interest and principal payments constituted dividends to the shareholders: ". . . It is, in our opinion, unreasonable to ascribe to the husband-petitioner, E. R. Gooding, an intention at the time of the issuance of the notes ever to enforce payment of his notes, especially if to do so would either impair the credit rating of the corporation, cause it to borrow from other sources the funds necessary to meet the payments, or bring about its dissolution . . ." (23 TC 418).

Although the Tax Court has relied upon the ratio test in some later cases, the subordinate role given to the test in *Gooding* should give all practitioners great concern in passing on any suspected thin incorporations.[19]

As a result of the great difficulty which the entire question presents, and perhaps principally motivated by the confusion compounded by *Gooding*, the American Bar Association Taxation Section is sponsoring a bill to codify the tests to be applied to determine whether a corporation is "too thin." The proposed requirements for not being "too thin" are fourfold:

1. Shareholder notes are not subordinated to the claims of the other trade creditors;

2. Repayment of the principal amount of the notes is not dependent upon corporate earnings and the notes are unconditionally payable at maturity;

3. When qualifying under some but not all of the above requirements, the taxpayer can establish by a preponderance of the evidence the failure to qualify was due to the corporation's business requirements;

4. If the ratio exceeds ten to one based on book values, the excess debt will not qualify as bona fide debt.

Although the above recommendation was apparently a compromise between suggestions to eliminate the ratio limitation entirely and those to limit it even more stringently, the proposal was acceptable to a majority of the ABA Committee and will probably be approved by most practitioners, if only to codify a situation in which confusion has become the general rule.[20]

Two-class common

No doubt the most exciting and controversial development of the past two years was the *Citizens Utilities* common stock plan. Under this ingenious arrangement, the corporation issues two types or classes of common stock. This

[15] Rev. Rul. 57-132, IRB 1957-14, 7.
[16] Rev. Rul. 56-654, IRB 1956-51, 12.
[17] 28 TC No. 11.
[18] 23 TC 408, *aff'd* 236 F.2d 159 (CA-6 1955).
[19] See, e.g., John W. Walter, Inc., 23 TC 550 (1954); R. M. Gunn, 25 TC 424 (1955); Ainslee Perrault, 25 TC 439 (1955).
[20] See 6 JTAX 262.

could be done as part of the original incorporation, or by a stock dividend or by a recapitalization. One class of common pays regular cash dividends. The other class of common pays no cash but distributes only stock dividends.

This two-class common stock plan serves a real business need of permitting corporate earnings to be retained to finance growth and expansion, and from a shareholder's viewpoint attracts investors to the type of stock designed to fit their individual needs. Citizens Utilities Co., which arranged its two classes of common by way of recapitalization, secured a favorable ruling from the Service. This ruling had an electrifying effect on other corporations and tax planners, who immediately recognized the great corporate and tax advantages of the plan. Their enthusiasm was soon killed, however, by a proposed amendment to the Regulations covering Section 305 of the Code.[21]

The amendment which was proposed about a year ago practically nullified the *Citizens Utilities Co.* ruling, by holding in effect that the arrangement gives the stockholder an election to take cash or stock and hence the distribution is taxable under the elective feature of Section 305. Counsel for the Citizens Utilities Co. and other authorities think the amendment to the Regulations (which apparently is still pending) is wrong, but until the controversy is resolved, we think a cautious approach to this ingenious plan is indicated.[22] Meanwhile it is entirely possible that the troublesome problem as to the so-called election under Section 305 and the possible Section 306 question could be eliminated *if* the plan is adopted at the time of incorporation and *if* the articles, by-laws and stock certificates are drawn so that the common stockholder is given no choice as to the type of distribution on the stock which he buys. Even the use of the plan at incorporation time would require considerable study, but we mention it here as a possibility.

No cert. on Casale, Prunier

IT IS ANNOUNCED that the Government will not ask certiorari in either *Casale* (247 F.2d 440 (CA-2)) or *Prunier* (CA-1, 11/8/57), cases that have been extensively commented on in this journal. In each of these cases the circuit court reversed a Tax Court holding that the payment of life insurance premiums by a closely held corporation was income to the stockholders. In each case, the circuit court emphasized the fact that the policies were assets of the corporation subject to claims of its creditors.

Popularity of non-voting common

One of the significant capitalization trends of the 1950's is the upsurge in the use of nonvoting common. No doubt the passage of Section 305, insulating practically all stock dividends from income tax, has had much to do with its increased popularity. Another factor, we think, is that Section 306 has plainly discouraged the use of preferred stock and often the nonvoting common can serve the same function as the preferred. Many tax men fear preferred stock because of the "taint" of Section 306, without fully realizing that it can often be removed as we had indicated earlier. Here are some typical and popular occasions for using non-voting common stock, which we find appealing:

Participation by key employees

Suppose a closely held company correctly concludes the issuance of stock to key employees would encourage their loyalty and incentive and assure they would stay with the corporation. But the present owners of the business are unwilling to relinquish any voting rights. Here the use of nonvoting common is an ideal solution and it may be issued either as deductible compensation or it may be sold to the employees under a qualified stock option plan.

Charitable donations

We indicated earlier that preferred stock was being used as a vehicle for charitable donations. Nonvoting common is also excellent for this purpose, and in some cases is better to use than preferred where the corporation should not be shackled with a fixed dividend obligation. A gift of nonvoting common will likewise minimize estate taxes without any relinquishment of voting control.

Gifts in estate planning

Probably the most frequent occasion for nonvoting common is to accomplish an estate planning gift. A father or a grandfather may immediately achieve a considerable saving in his estate taxes without indulging in fears of spoiled children or unwelcome sons-in-law ever interfering with the corporate policies or operations.

Corporate acquisitions

A lesser-known but significant use for nonvoting stock is as an adjunct to corporate acquisitions. A publicly owned or a closely held corporation may be unwilling to dilute its voting control and yet be forced to issue additional common stock in order to acquire another company. Needless to say, nonvoting common is a perfect answer to this acquisition problem.

Recapitalization v. stock dividend

Stock dividends are, of course, nontaxable, by Section 305(a), 1954 Code. That section presumably also applies to standard stock splits.

However, with respect to recapitalizations where, for example, some shareholders exchange common for preferred and others retain common, a recapitalization results and the parties must establish "business purpose." *Marjorie N. Dean* and *Elmer W. Hartzell (supra).* Therefore, whenever it is possible to accomplish the desired results as well via the stock dividend route (perhaps utilizing nonvoting common) as by the recapitalization method, most practitioners prefer the former.

This is especially true since enactment of Sections 354(a)(2) and 356 of the 1954 Code, which now preclude tax-free treatment to a recapitalization wherein stock is exchanged for debt.

"Disproportionate" problems

Another potential trap to be avoided if subsequent partial redemption is contemplated is present on a nonvoting common dividend on common. It should be remembered that the subsequent redemption of the nonvoting common alone cannot qualify as "disproportionate" under 302(b)(2). In addition, the ratio of nonvoting to voting might even prevent a disproportionate redemption where some of both classes is later redeemed, although disproportionate treatment might have been available if the nonvoting ratio had been carefully limited originally.

Stock warrants

One of the current phenomena of the corporate capital markets is the growing use of stock warrants. Stock warrants are not new. They were quite popular in the

[21] Reg. Sec. 1.305(b)(2), Fed. Reg., July, 1956.
[22] As of the date of this writing we are advised that the amendment had not been adopted. See also 4 JTAX 178.
[23] Rev. Rul. 56-572, IRB 1956-46, 8.

1920's and 1930's and were sometimes issued in reorganizations to placate unhappy stockholders who had gone through the bankruptcy ringer. Now in the past year or two there has been a veritable flood of stock warrants issued, many of these by industrial giants. There is an active market today for the warrants of about 50 different corporations in the U. S. and Canada.

The great and increasing popularity of the stock warrant can be traced to the tight money market. Thus, when Kerr-McGee, a large and popular petroleum company recently attempted to issue several million dollars worth of new debentures, it found the market for the new issue sticky and after consulting with its underwriters, it amended its SEC registration, so that each new debenture would have a stock warrant attached. The warrant itself would have a considerable speculative value and would make the debenture easier to sell.

General Tire did the same thing last year and has just repeated it again in October of 1957, with a $12,000,000 issue of 6% debentures, to which stock warrants are attached. Only a few days before these notes were composed, investors greeted with enthusiasm another important stock warrant issued by the huge and growing Sperry Rand Corporation. 2,200,000 warrants were issued with a $110,000,000 sale of Sperry Rand 5½% debenture bonds. Immediately a separate market has been established for these warrants at about $4.50 per warrant.

Great fortunes have been made in stock warrants in the past and great losses have been realized by uninformed speculators. No doubt this process will continue at a more rapid rate. Meanwhile corporate tax and financial advisors should become more fully aware of the importance of stock warrants as a major vehicle of corporate finance and as an aid in acquiring other companies. Warrants can be readily adapted to closely held campanies particularly as a means for attracting new investments, since they afford unusual opportunities for capital gain.

From a tax standpoint stock warrants could be issued as a tax-free dividend under Section 305, or possibly in connection with a recapitalization under Section 368. More often they are bought for cash as part of a package sale of stock or debentures. Interesting problems of allocation of basis and holding period with respect to stock warrants have already been presented and ruled upon recently in *Rev. Rul.* 56-572.[23] ☆

New corporate decisions this month

Court allows $25,500 of $27,000 salary as reasonable. Taxpayers were the officers of a family owned corporation from which they received $27,000 a year salary. The court, after hearing expert testimony, allows $25,500 as reasonable. *French Broad Ice Cream Co.*, DC Tenn., 9/9/57.

Farmer's advances to marketing corporation nonbusiness. Taxpayer-farmer advanced about $46,000 to a corporation which he helped organize to engage in the business of shelling and marketing peanuts. The Tax Court found that the advances were loans rather than contributions of capital. However, taxpayer is entitled to a nonbusiness bad-debt deduction only. He was not in the business of lending money to corporations generally, and while the corporation was conceived of as an aid to his business of raising peanuts, it was an independent venture. This court affirms. *Gulledge*, CA-4, 11/7/57.

Lawyer's advances to corporation a nonbusiness bad debt. Taxpayer, a lawyer, lent money to a corporation in which he owned stock. The court holds that, on the insolvency of the corporation, he suffered a nonbusiness bad debt, rather than a business bad debt. The lawyer was found not to be engaged in the business of financing or promoting corporations. *Williamson*, 29 TC No. 8.

Issuance to stockholder meets plan for company and/or stockholder. [*Acquiescence*]. According to the formal plan, assets were to be transferred by a corporation and the stock for them was to be issued to the corporation "and/or" its stockholders. The court held that issuance to the stockholders was in accord with the plan. (Nonacquiescence 46 CB XV-2 withdrawn). *Smith*, 34 BTA 702, *acq.* IRB 1957-45.

Parent cannot deduct capital loss carryover of liquidated subsidiary. A personal holding company acquired all the stock of a subsidiary in 1948 and liquidated it in 1949. Even though the parent filed a consolidated income tax return with the consent of the affiliate for 1949, the Tax Court held it cannot use as a carryover any of the net capital loss sustained by the affiliate in 1948. The court reasoned that the affiliate's deductions could be used only by it, that the existence of the affiliate was terminated by liquidation, and that it did not survive as a component of the parent. This court affirms. *Patten Fine Papers, Inc.*, CA-7, 11/26/57.

Distribution a tax-free spinoff under 1939 Code. Taxpayer was one of several stockholders in a finance company and in an insurance agency which handled much of the insurance on collateral for the finance company. However, the insurance agency was not permitted to do certain business and for that purpose a new company was formed. The agency received stock in the new company for assets it turned over. The stock was then distributed by the agency to its stockholders. Similarly, a real estate corporation was formed in which the agency received stock for assets and the stock was also distributed to the agency stockholders. The court holds that both spinoffs were tax-free under the 1939 Code; there was business purpose for the reorganizations. [Section 355 of the 1954 Code permits spinoffs but imposes an active business test.—*Ed.*] *Murdock*, DC Tenn. 9/27/57.

Family trust of business not taxed as corporation [*Non-acquiescence*]. The grantor of this trust transferred a going business to it and he was hired as general manager; he, together with his sons and daughter remained as trustees. The Tax Court held it should not be taxed as a corporation—the disposition of the business upon the death of the grantor was fixed by the trust instrument, income was not distributable according to capital contributions and the beneficiaries had no voice in management. (Acquiescence 1937-2 CB 17 withdrawn). *Lyman Trust*, 36 BTA 161, *nonacq.* IRB 1957-45.

Surplus accumulation was within reasonable needs of business for two years, but unreasonable in third. An accumulation of earnings in the amount of $70,000 in 1948, and $107,000 in 1949, by a corporation providing banks with all equipment and materials necessary for operating special checking accounts, is held not to have been improperly ac-

cumulated beyond the reasonable needs of the business so as to subject the corporation to a penalty surtax. The corporation contemplated using the earnings for replacing of equipment, for a reserve for pending litigation, and for writing down worthless assets. However, in 1950, when accumulated earnings totaled $174,000, the court finds taxpayer was availed of for the purpose of preventing the imposition of the surtax upon its stockholders through the medium of permitting earnings and profits to accumulate instead of being distributed. *Casey*, TCM 1957-226.

Purchase of stock, liquidation and transfer to a new company treated as purchase of assets by it. Three individuals sought to purchase the assets of a paper mill corporation as a source of supply for their paper jobbing business. When the owner refused to sell the assets, they purchased the stock for $500,000, $150,000 in cash, and $350,000 in notes, which was approximately equal to the fair market value of the net assets. The individuals then dissolved the corporation and distributed the corporate assets to themselves. Immediately thereafter they transferred the assets to a newly formed corporation which assumed the $350,000 liability of the three individuals, and issued to them notes for $150,000 to cover their cash payment. Viewing all the steps as one transaction, the court holds there was no reorganization, but the net effect was a purchase of assets by the new corporation from the old corporation. Accordingly, (1) the depreciation basis of the assets to the new corporation was its cost of the stock; (2) the individuals could not have received a dividend when the new corporation assumed their liability for the purchase of the stock. *Suter Estate*, 29 TC No. 29.

Reserve for bad debts income in year business liquidates. A reserve for bad debts which had been accumulated by additions for which a corporation derived full tax benefits in prior years constitutes ordinary income to the corporation in the year it completely liquidates. The IRS adds that this result is unaffected even though the reason for the end of the need is the liquidation and sale of assets within 12 months, tax-free under Section 337. *Rev. Rul.* 57-482.

Fees of loan company are personal holding company income unless valuable services rendered. Finance or service charges imposed on borrowers by a loan company are interest if the service for which the charge is made is not truly separable from that for the use of borrowed money. It follows that these fees are includible in personal holding company income. *Rev. Rul.* 57-540.

However, application and finance fees in connection with obtaining FHA and VA mortgages are not personal holding company income where the fees are (1) specifically authorized by the Government and (2) the company sells the loans to investors and retains no interest in them. *Rev. Rul.* 57-541.

Stockholders not taxed on life insurance premiums paid by corporation. A corporation in which taxpayers, two brothers, owned substantially all of the outstanding stock paid the premiums on life insurance policies on their lives. During the taxable year in issue each brother was named beneficiary of the other's policy. The Tax Court held as a fact that the brothers intended that in the event of the death of either, the corporation should be the owner of the proceeds for the single specific purpose of using the proceeds to purchase the stock interest of the deceased at a predetermined price. It concluded that the corporation was not a beneficiary of the policies, that the brothers were directly or indirectly the beneficiaries. Premiums paid by the corporation were therefore taxable to the brothers as additional compensation. This court reverses. The true owner of the policies under state law was the corporation. The Tax Court erred in disregarding the corporate entity. [See comment 8 JTAX 1]. *Prunier*, CA-1, 11/8/57.

Stock purchase is capital gain to stockholder bought out; dividend to others [*Acquiescence*]. A father owned 48 shares and his two sons one share each of the stock of a scrap iron corporation. In 1947, in anticipation of his remarrying, the father transferred 23 shares to each of his two sons. Later, in 1950, he and his sons became involved in a serious dispute and under a written contract the corporation agreed to pay the father $93,700. The father agreed to resign and to transfer to the corporation his remaining 2 shares; not to compete for ten years; and to relinquish all salary claims. The court held: (1) the father did not make a gift of 46 shares to his sons in 1947 since they were merely nominees whose names were used to suit his convenience; (2) the father sold all of his 48 shares in 1950 and was entitled to report all of the profit as capital gain; (3) the sons received a constructive dividend of $93,700 in 1950 when the corporation, which had accumulated earnings in excess of that amount, paid for the father's stock. *Zipp*, 28 TC 314, *acq.* IRB 1957-45.

Stock redemption to pay death taxes essentially equivalent to dividend (Old Law). Prior Section 115(g)(1) taxed as ordinary income a redemption essentially equivalent to a dividend. Taxpayer died owning 2480 shares out of 2500 shares of a family corporation. In 1949, 200 shares of the estate's stock were redeemed for $57,000 from the company's $650,000 of earned surplus to obtain funds to pay the death taxes. No contractions of operation were contemplated. The judge directed the jury to decide in favor of the Commissioner, who had argued that the uncontested facts left no doubt that the transaction was equivalent to a dividend. [Since 1950 certain redemptions, the proceeds of which are used to pay death taxes, interest and funeral and administration expenses, are treated as payment for the stock redeemed. — *Ed.*] *Smith Estate, (Wilson Ex'r)*, DC N. Y., 9/19/57.

Payments to stockholder in excess of reasonable compensation are dividends. Taxpayer-corporation was organized by a group of doctors to provide medical and surgical care to subscribers. The staff doctors, who were also the stockholders, billed the corporation on the basis of a predetermined schedule of fees which in some instances were, the court concedes, below reasonable compensation for the work performed. However, it holds corporate payments to the doctors to the extent of their billings for services rendered was reasonable compensation deductible as a business expense, while any payments in excess of such billings are to be treated as dividend distributions. *Klamath Medical Service Bureau*, 29 TC No. 37.

Corporate withdrawals were bona fide loans [*Acquiescence*]. Withdrawals of $152,000 from a real estate corporation by taxpayer and the other stockholders were evidenced by negotiable interest bearing notes. On the facts the court finds they were bona fide loans, not taxable dividends. *Benjamin Estate*, 27 TC 101, *acq.* IRB 1957-45.

THE TAXATION OF INDIVIDUALS
Personal tax problems
EDITED BY BENJAMIN HARROW, J.D., CPA

The special tax-deduction problems of professionals, salesmen, the retired

by **ARTHUR I. HEMMINGS**

The tax man advising individuals must be aware of the difficulties faced by people for whom the Code provides special treatment. The translation of the words of the Code into directions for arranging the individual's affairs is difficult at best and the tax man is required to be something of a prophet in advising clients covered by new sections; for example, those dealing with salesmen and retirement income. Mr. Hemmings points out some of the ambiguities in these sections and also reviews for us recent developments in the continuing litigation over older sections—expenses away from home and the deductions allowed professional men.

ALL ORDINARY and necessary business expenses incurred in the conduct of a profession are deductible in the same manner as the business expenses of all sole proprietorships.[1] Thus, the professional man is entitled to deduct his office expenses including rent, salaries, utilities, supplies, his auto expense, entertainment, convention expenses, etc. If he maintains an office at home which is actually used in his business, an allocable portion of the total maintenance cost of his home is deductible.[2] Some individuals have sought to take a home office deduction when the only thing in their home resembling an office is a private study. This abuse has caused the Service to become suspicious of all claims for home offices except in those cases where the individual actually practices his profession from his home.

The entertainment deductions of a professional man require the same degree of proof of expenditures and business purpose as those of any other businessman, but with an added handicap in proving that the entertainment was of a business nature. Very few professional men can engage in advertising and their only means of making themselves and their services known is through entertainment of clients, potential clients, or referring colleagues. Unfortunately, these same persons are generally found to be a part of the social group of the professional man, such as members of his club, classmates, etc., and the problem of proving that the entertainment of a friend was essentially business in nature becomes difficult. It is essential, then, that the individual maintain as detailed a record as is possible to show that the persons entertained were clients, or became clients after being entertained, or that referral cases were received from colleagues who were entertained. The stronger the proof of a tie-in between entertainment and client, the greater the portion of the deduction that will be allowed. As an example, a doctor who specializes in some particular field of medicine and who depends in large part upon references from other doctors, can buttress his entertainment deduction by tieing in his case record with a referring doctor and the entertainment function at which this referring doctor was entertained.

Automobile expenses are deductible by professional men just as they are by any other sole proprietors, providing the use is in connection with their profession.[3] Again, the principal problem is one of proof. Only in rare cases is an individual's auto used 100% in his profession, and a proper allocation as between personal use (including commuting) and business use must be made. Even in those cases where two cars are owned, care must be taken to keep the expenses of the two cars separate. If this is done, experience indicates that the Service will not require much more than a token allowance for personal use when the business car is used essentially for that purpose. Naturally, if the car used by the professional man is solely for traveling to and from work, no deduction is permissible.

The deductibility of educational expenses depends solely on the form in which incurred. The cost of a postgraduate course, or other specialized formal training is not deductible.[4] However, similar training presented at a conference or convention is deductible.[5] Furthermore, the cost of technical literature, dues to professional societies, etc., are deductible, but the cost of taking a professional examination is not.[6] Apparently the current situation is that expenses incurred in formal training such as postgraduate work are nondepreciable capital additions to the mind, whereas knowledge gained from conferences, publications, technical associations, etc. merely keep the mind in ordinary operating condition.

Expenses but no income

The foregoing discussion relates to the problems of professional men admittedly carrying on a business, but in certain professions a further problem is presented in proving that a trade or business is being carried on. For example, the expenses of a writer are deductible in the year incurred without regard to the amount of income during that year, provided his writing purpose is the production of income. This presents no problem for an established

[1] Prop. Reg., Sec. 1.62-6.
[2] V. T. H. Been, 20 TC 49; IT 3929, 1948-2 CB 29.
[3] Prop. Reg., Sec. 1.162-1.
[4] Prop. Reg., Sec. 1.162-5.
[5] Coughlin, 203 F.2d 307; Bistline, 145 F. Sup. 802.
[6] Prop. Reg., Sec. 162-5(d).
[7] Prop. Reg., Sec. 1.62-1(h).
[8] Prop. Reg., Sec. 1.62-1(h).
[9] Flowers, 326 U.S. 465.
[10] Harold R. Johnson, 17 TC 1261.
[11] David G. Anderson, 18 TC 649.
[12] Rev. Rul. 54-497, 1954-2 CB 75.
[13] Horace E. Podenis, 24 TC 21.
[14] 1954 Code, Sec. 62(2)(c). Prop. Reg., Sec. 1.62-(g).
[15] Kenneth Drummond, 43 BTA 529.
[16] C. E. Shockey, TC Memo Op, Dkt. No. 9522 (1947).
[17] 1954 Code, Sec. 37.

[*Arthur I. Hemmings is a CPA and a partner in the Miami, Florida, accounting firm of Ring, Mahony & Arner. This article is based on a paper written for the Seventh Tulane Tax Institute.*]

author as he is clearly in the business of writing, but for the beginner or little-known writer, it is a serious obstacle. Often, in the case of a beginner, a number of years will elapse from the beginning of a work to its completion, with substantial research, clerical, supplies, and transportation expenses being incurred in each of the years. His returns will show substantial deductions with little or no offsetting professional income, and if he has not made a substantial sale by the time of examination of his return, he may face a disallowance of his expenses. This problem is faced by inventors, artists, and musicians. In addition to the ordinary records covering proof of expenditures, documentary evidence such as letters seeking commissions for works to be produced, rejection slips, etc., should be ascertained and a diary setting forth personal efforts to sell completed works should be prepared.

The outside salesman

Salesmen fall into three general categories, i.e., employees who are outside salesmen, employees who are inside salesmen, and independent contractors. The independent contractor classification generally covers manufacturers' representatives, some real estate salesmen, etc., who are treated for tax purposes as sole proprietors.

Prior to the 1954 Code, employee-salesmen whether "inside" or "outside" were treated like all other employees in determining which items were deductible from gross income in arriving at adjusted gross income. Reimbursed expenses and travel expenses incurred away from home were deductible from gross income, but such items as stenographic services, entertainment, commissions, etc. were deductible only as itemized deductions. Section 62(2)D of the 1954 Code created a new class of employee—the "outside" salesman. The net effect of the new provision is to place outside salesmen, even though they are employees by every test, in the tax status of independent contractors. This permits the outside salesman to deduct all business expenses incurred in his selling activities from gross income in arriving at adjusted gross income, and still enables him to use the standard deduction. The "inside salesman," on the other hand, retains his former status as an employee, and can deduct his business expenses, other than transportation, travel and reimbursed expenses, only as a part of itemized deductions.

The substantial tax difference flowing from this distinction indicates the necessity for understanding the difference between the two classes. An outside salesman is an individual who solicits business as a full-time salesman for his employer, away from the employer's place of business. He may, however, perform incidental inside activities at his employer's place of business such as writing up and transmitting orders, and receiving and making telephone calls. The term does not include a taxpayer most of whose time is spent away from the employer's place of business but whose principal activities are service and delivery. For example, a bread driver-salesman or milk driver-salesman would not qualify as an outside salesman.[8] Naturally, any employee-salesman not qualifying as an "outside" salesman would automatically be an "inside" salesman. It should be noted that neither the Code nor proposed Regulations contemplate a hybrid status—a taxpayer is either one or the other.

Obviously, many borderline cases are going to confront us. For example, an automobile dealer may require a regular outside salesman to relieve one of the floor salesmen for lunch. The outside salesman is clearly doing more than writing up orders, and if proposed Regulation 1.62-1 is followed, this inside activity would entirely deprive him of his outside salesmen's category. Until the question of the limits of incidental activities is settled, the salesman would be well advised to have a clear understanding with his employer, preferably in a written employment contract, as to the nature of his duties, showing that he is primarily engaged in selling away from the office.

What is "home"

Section 62(2)(B) of the Code provides that a taxpayer may deduct travel, meals, and lodging expenses incurred away from home in the course of business. It is now well established that "home" does not necessarily refer to the place of residence, but rather to the principal place of business.[9] In one case,[10] a taxpayer lived with his family about 200 miles from his employer's principal place of business. His work required him to be on the road about 50% of the time. When he was at his employer's principal place of business he stayed at a hotel. The court held that his "home" was where his employer was and that while he could deduct travel expenses incurred away from there, he could not deduct his expenses while at the employer's place of business. In his consideration of his deductible travel expenses a salesman, either inside or outside, must consider his employer's place of business as home and start computing his travel expense after he leaves the place of business.

A further problem exists in the determination of what is "away from home." For many years the Service insisted that to be "away from home" required at least an overnight stay although such requirement was not in the Code. Following the *Anderson*[11] decision, the Service receded slightly from its overnight requirement, and in 1954 published a lengthy ruling[12] which sets forth its current position. It now says that "overnight" is absence from home for a minimum period which lasts substantially longer than an ordinary day's work and during which his duties require him to obtain necessary sleep away from home. The Tax Court, however, does not necessarily require that a trip last overnight in the same sense that the Service does. It generally considers that an individual may be on travel status if he must leave the metropolitan area where his home office is, even though he returns on the same day.[13] In view of the Service's rather determined position on this matter, it is very likely that unless a taxpayer can meet the Service's test, he will be able to get his deduction only after litigation. It should be remembered that the employee will be entitled to deduct his transportation expenses whether or not he is away from home "overnight" and that the only thing to be disallowed is the cost of his meals.[14]

One of the ever-recurring problems of salesmen is the time for reporting income. There are numerous methods in common use for compensating salesmen, but nearly all involve either straight commission, salary plus commission, drawings plus commissions, or straight salary. The straight commission, straight salary and salary plus commission methods, ordinarily present little difficulty—earnings are taxed to the employee when paid to him or credited to

his account subject to his unrestricted withdrawal. However, the status of a salesman working on a commission-withdrawings basis is not as clear. The general rule if the drawing is guaranteed compensation (i.e., does not have to be paid back if the salesman is overdrawn when he leaves the job), is that the salesman must pay tax on the amount of the guaranteed drawings in the year drawn and on any commissions received in excess of the guaranteed drawings.[15] If the commissions are less than the drawings he still pays on the drawings, but will not have to pay on subsequent years' excess commissions until the overdraft in his drawings is made up. The general rule, if the drawing is not guaranteed compensation (i.e., must be paid back if the salesman is overdrawn when he leaves the job), is that he reports only the commissions actually earned — any excess drawing is in effect only a loan.[16]

The retirement income credit first introduced in the 1954 Code[17] is an attempt to place retired individuals with private retirement income on an equal footing with those receiving tax-exempt social security benefits. The retirement income credit allows individual taxpayers who have reached the age of 65 a credit against their income tax liability which may be as high as 20% of the first $1,200 of retirement income. If the retired individual is under 65, and is under a public retirement system, he is allowed a similar credit but only against the pension or annuity received under the retirement system. The credit cannot exceed the income tax (computed without the credit) reduced by the tax withheld on tax-free covenant bonds and by the credits for foreign tax, dividends received, and partially tax-exempt interest.

Retirement income for retired persons under the age of 65 includes only the pension or annuity received from a public retirement system, and then only to the extent it is included in gross income. For retired persons over 65, retirement income includes pensions and annuities, interest, rent, and dividends, to the extent they are included in gross income. Remember, it is gross rent which is included in retirement income, and not net income from rent. Furthermore, interest from tax-exempt bonds, and the excludible portion of an annuity are not included in retirement income.

The maximum amount of retirement income on which the credit can be computed is $1,200, less any amounts received as pensions or annuities under the Social Security Act, Railroad Retirement Acts, military retirement or other retirement pensions which are excludible from gross income. This reduction is not required, however, for amounts excluded from gross income as a return of investment on an annuity, life insurance proceeds, disability benefits, or from employees' trusts or annuities.

The retirement income is further reduced by earned income received in excess of $900 by a person under 65 or in excess of $1,200 by a person from 65 through 71. For individuals 72 or over there is no reduction, regardless of the amount of earned income.

To qualify for the retirement income credit, an individual must have received earned income of at least $600 in each of any ten calendar years before the taxable year. A widow or widower, whose spouse had received such earned income, shall be considered to have received earned income. In community property states, if either spouse has earnings which constitute community income, each spouse will be considered as having earned one-half of it. In those states, the combined earned income of husband and wife for each of the ten years in the qualifying period must be $1,200, but this has the advantage that both spouses will qualify for the credit.

Earned income is generally compensation for personal services, and does not include pensions or annuities. In the case of sole proprietorships and partnerships in which both capital and services are income-producing factors, a reasonable allowance for compensation will be considered as earned income but not over 30% of the individual's share of the net profits.

Based upon the foregoing description of the mechanics of the retirement income credit, it is obvious that the area of greatest potential conflict with the Service is in proving that the taxpayer had earned income of $600 in any ten of the prior years. This can be particularly difficult if the taxpayer is now of a very advanced age and may have retired as much as 20 years ago. Even more difficult is the case of an elderly widow who never worked and whose husband has been dead for many years. In these cases, documentary evidence such as income tax returns, books of old businesses, payroll records of employers, etc., may be long since destroyed. Fortunately, agents of the Service have been very cooperative in these extreme cases, accepting the unsupported explanations of taxpayers when reasonable. There is no assurance that they will continue their liberal policy after taxpayers have had a chance to become familiar with the qualification requirements. For this reason, it is very important that all taxpayers prepare a permanent record of their qualification, for use when the credit will be available to them or their surviving spouse.

There are many instances where both a husband and wife qualify for the retirement credit by reason of their both having worked in their early years, but

IRS SAYS REIMBURSEMENT RECORDS MUST BE KEPT IN 1958

THE IRS released, as IR-206, a statement by Commissioner Harrington as follows:

Taxpayers will not be required to answer line 6 (a) of the 1957 individual income tax return Form 1040, and, thus, employees will treat travel, reimbursed expenses, etc., for 1957 as they have in the past. All Internal Revenue district offices are being so informed.

This action is taken because the decision to include a new line in the 1957 income tax return Form 1040 was not made public until ten months of the tax year had passed, and hence had a retroactive effect. Taxpayers have emphasized to the Service that most employees who receive *reimbursements* for expenses file bills and receipts with their employers and do not retain copies. To attempt now to secure data would place too great a burden on many taxpayers. (Emphasis supplied.)

This decision does not change the long-standing rules which the Revenue Service has been following with respect to substantiation of deductions when a taxpayer's return is audited.

For the year 1958, all individual taxpayers who incur expenses in connection with their employment should keep adequate records of their expenditures and *reimbursements* so that for 1958 and later years they will be in a position to supply expense account information from their own personal records. ☆

the wife has no retirement income to enable her to take advantage of the credit. In appropriate cases it may be possible to secure as much as an additional $240 tax credit, merely by putting income-producing property in their joint names and splitting the income. The result could be obtained by outright gifts of income-producing property to the wife.

In time, the retirement income credit will gradually lose its importance unless there is a substantial change in the law. As was noted above, the receipt of social security benefits reduces the amount of the retirement income credit. In recent years there has been a gradual increase in the coverage and in the amounts of benefits provided through the social security system. Already, the maximum benefits under social security tend to eliminate the retirement income credit, and the percentage of persons receiving maximum benefits will increase regularly. However, as the basic reason for putting the retirement income credit in the Code was to put social security beneficiaries and retired individuals with private retirement income on a parity, there can be no valid objection to the "wasting asset" nature of the credit. ☆

IRS and Ways and Means Committee attack annuities for employees of charities

CHARITABLE organizations under pressure to make their limited funds stretch as far as possible have traditionally depended on a great deal of volunteer labor; employees they do pay rarely receive the full market value of their services. Many charities were interested, therefore, in the possibility of paying for part-time services from professionals, usually doctors, by buying annuities in such a way that there would not be taxable income to the employee. Section 403(a)(1) provides that "if an annuity contract is purchased for an employee by an employer described in Section 501(c)(3) . . . the employee shall include in his gross income the amounts received under such contract for the year received . . ." The 1939 Code had a similar provision. (Section 501(c)(3) lists the 16 types of organizations exempt.)

Thus, if a charity purchased an annuity contract for its employee, the payment of the premium would not be income to the employee; he would have no income until he collected under the policy. Obviously, such an offer would be very attractive to a high-income professional who wished to assist the charity but to whom additional salary, particularly the low salary charities can afford, had little appeal.

In the Regulations on the 1954 Code, the Commissioner took a very restrictive position. Section 1.403(a)-1 provides that "An employee or retired or former employee for whom an annuity contract is purchased by his employer is not required to include in his gross income the amount paid for the contract at the time such amount is paid, whether or not his rights to the contract are forfeitable, if—(3) the annuity contract is purchased by an employer which is an organization described in Section 501(c)(3) and exempt under Section 501(a), provided the purchase of the annuity is merely a supplement to past or current compensation. For the purpose of this subparagraph, whether the purchase of an annuity contract is merely a 'supplement to past or current compensation' is to be determined by all the surrounding facts and circumstances. One of the pertinent facts to be taken into consideration is the ratio of the consideration paid by the employer for an employee's contract to the amount of his past or current compensation. For example, if the annual premium paid for an employee's contract is $1,000 and his annual salary is $10,000, the ratio indicates that the premium paid for the contract is merely a supplement to the employee's current compensation. If, however, an employee receives no current compensation, or the annual premiums paid for his annuity contract approximate his annual salary, the amount paid for his contract will be considered to be current compensation and taxable to the employee in the year in which it is paid by the employer. Other pertinent considerations are whether the annuity contract is purchased as a result of an agreement for a reduction of the employee's annual salary, or whether it is purchased at his request in lieu of an increase in current compensation to which he otherwise might be entitled. In such cases, the amount paid for the contract shall also be considered to be current compensation."

The validity of the Regulation is being tested in a case now before the Tax Court (*Llewellyn*, Docket No. 69,807). Taxpayer in that case was a pathologist for several hospitals who received as compensation a fixed percentage of the fees for laboratory services charged by the hospital to patients. Then, in a year governed by the 1939 Code, the hospital took out an annuity policy for his benefit and amended his employment contract to provide that the amount due should be reduced by the amount of the premiums paid directly by the hospital to the insurance company. The taxpayer argues that this change was not made at his request but continues that in any event even if he had requested it, the Regulation is invalid and that he is not taxable on the premiums.

Those who are interested in this type of arrangement must not only watch this case to see whether the courts will sustain the Commissioner's position; they must watch another development. The Technical Amendments Act of 1957, as adopted by the House Ways and Means Committee (H. R. 8381) contained a provision which would limit the amount that could be excluded by an employee of a charitable organization to 20% of the employee's compensation for the current year, plus a past-service allowance. This is how the Ways & Means Committee's report described the action it proposed:

"Under Section 403 of present law an annuity purchased by an employer under a qualified nondiscriminatory type of plan is taxable at the time the employee receives the annuity payment rather than in the year the payments are made for the annuity by the employer. However, where the employer is a tax-exempt educational, charitable, or religious organization, described in Section 501(c)(3), this deferment of tax in the case of the employee is available with respect to annuities whether or not they are paid under a qualified nondiscriminatory type of plan.

"It has been called to the attention of your committee that certain of these organizations are paying selected employees all, or almost all, of their compensation in the form of annuities. Usually these are part-time employees of the organization who derive their principal income from other employ-

ment, and desire to be compensated by the organization in the form of an annuity rather than money, as a means of deferring tax on funds they in any case intend to save.

"Your committee does not believe that these organizations should be permitted to trade on this tax-deferment privilege for their employees. Accordingly, your committee has added a new sub-section to Section 403 which provides that in the case of annuity contracts purchased for employees by educational, charitable or religious organizations exempt under Section 501(3)(c), if the annuity contract does not come under a qualified nondiscriminatory plan and the employee's rights to the contract are nonforfeitable, the amount contributed by the employer is to be excluded from the gross income of the employee in the taxable year of the contribution only to the extent the contribution does not exceed an 'exclusion allowance' for the year. The 'exclusion allowance' is 20% of the employee's compensation for the current year, plus a past-service allowance. The past-service allowance is 20% of an amount represented by the number of years of past service times the current rate of compensation of the employee reduced by any amounts previously set aside by the employer in annuity contracts for the employee which were excluded from his gross income."

While this particular bill failed of passage, the odds are usually good that when the Ways and Means Committee formally takes a position on a proposal, it is not dead, only sleeping. We are likely to hear of it again. ☆

When preparing a client's personal return, prepare for examination

THE BEST time to gather together the data the revenue agent will require for auditing a personal return is the time the return is prepared. The source material itself (or a note on the place where it can be found), the computations, memos on authority for handling of doubtful items, all of these can best be prepared while assembling the data.

An experienced practitioner can tell pretty well what questions an agent will ask about any particular return. But the IRS tends to shift emphasis from time to time and sometimes the clues to the items that are going to get special attention are in the talks high-ranking officials make before professional bodies.

For example, if you prepare a return claiming dependency exemptions for someone outside the immediate family of the taxpayer, you will want to bear in mind a comment by Commissioner Harrington before the New England Graduate Accounting Study Conference, recently. Large dependency claims and claim for dependents outside the family, even on simple returns (all income subject to withholding, standard deduction claimed), he said, receive "sufficient selection to constitute a check for compliance" by these taxpayers. Office audit is the technique used.

Among other interesting comments, Commissioner Harrington said: "Aside from simple returns, we audit about one return in ten. We don't take just each tenth return filed. Returns selected for investigation may be indentified by type of return, by type of business occupation, by size of income, or by type of error. Certain types are 'automatically' selected."

Examples of these types are personal or business returns reporting adjusted gross income above certain designated levels; or combinations of personal service and business income above certain levels.

Further selection for audit may be made on the basis of such factors as substantial income reported from sources not subject to withholding; or income from professions or businesses which deal largely in cash; or returns from such enterprises that local experience has demonstrated to be error-prone; or returns presenting unusual dependency exemption claims; or proportionately large deductions.

Beyond these more or less standards of selection, each Director's staff may "branch out," so to speak, into various areas, as manpower permits, even varying from year to year. For example, a particular profession or business may receive special attention one year, and another the next, by way of determining the extent of non-compliance or frequency of error.

Our experience has identified certain areas of tax reporting as particular trouble spots: such items in the individual tax return as dependency claims, and deductions for church, charities, etc. Other such items are the sick pay exclusion, and the medical expense deduction.

Then there are the matters of unreimbursed expenses of salesmen or executives, and the accounting for blanket expense allowances by employers, which may raise questions of actual, verifiable expenses of the recipient as against additional compensation to him.

For some time, in our audit program, we have been giving particular attention to this area.

We recently gave additional instructions to our auditors to take an even closer look at expense deductions covering such items as club dues, entertainment, travel, maintenance of automobiles, yachts and airplanes, maintenance of company-supported residences, etc.

One area receiving close attention involves use of alleged branch offices installed in resort communities for the sole purpose of sending business executives to such cities for vacations.

Other dubious instances that have come to our attention include deductions, as expenses, of purported business trips by executives vacationing at resort hotels, expenses of hunting trips, expenses of attending sporting events in distant cities, and for other nonbusiness expenses under the guise of business trips. Our policy is to scrutinize expense accounts closely for abuses. To a considerable extent, this is a matter of business morality, as well as legal interpretation.

Taxpayers with deductions in the expense account and related categories particularly should maintain adequate records and be prepared to document such items. ☆

New decisions affecting individuals

First husband increases alimony to finance second! it's deductible. Taxpayer and his wife were divorced in June 1942. Two months earlier they entered into an agreement which was made part of the divorce decree and which provided

for alimony payments for the remainder of the wife's life or until her remarriage. In 1948, the wife told taxpayer she intended to remarry a man who was "relatively impecunious." In order to enable her to remarry, taxpayer entered into a new agreement with her. Payments under this new agreement were held by the Tax Court incident to remarriage rather than divorce and were therefore not deductible as alimony payments. This court reverses; the payments were also incident to the divorce and as such deductible. *Hollander,* CA-9, 10/21/57.

Husband can't use his former wife's estimated tax payments. A husband and his former wife agreed to file separate returns and to split their community income for 1951, the year in which they were divorced. The wife also agreed to "reimburse" the husband for any amounts of additional tax which might result from the inclusion in his return of such community income. The Tax Court held that there was no marital community in existence and that the husband, who had remarried in 1951, could not report half of his former wife's income. Accordingly, he was not permitted in filing a 1951 joint return with his second wife to claim a credit against his tax for estimated tax payments made by the former wife whether before or after the divorce. This court affirms. *Gooding,* D. C. Cir., 11/7/57.

Partner's gross income (for dependency test) is share of gross income of firm. Taxpayer's mother was an equal partner with him in a business which had in 1952 gross profits of about $210 and a net operating loss of over $1,700. In determining the mother's gross income for purposes of qualifying her as a dependent, the court holds her share of the partnership's gross income must be taken into account. Since her gross income so determined exceeds $600, taxpayer is denied a claimed dependency credit for her. However, he is entitled to a deduction for medical expenses paid for her. It is not required that an exemption be allowed for medical expenses of a dependent to be deductible. For that the only tests are relationship and over half the support. The cost of special foods for the mother, i.e., baby foods and tender meats, which are substitutes for foods normally consumed, do not qualify for medical expenses. [The 1954 Code specifically provides that gross income of a partner is his share of the gross income of the partnership.—*Ed.*] *Clark,* 29 TC No. 24.

Agreement didn't fix children's support; payments are alimony. A separation agreement incorporated in a divorce decree required taxpayer-husband to pay $250 a month to the wife for the support of herself and her two minor children. The payments were to be cut in half on the death, emancipation or attainment of age 18 of one of the children, and were to be entirely eliminated on the death, emancipation or attainment of age 18 of both. The Tax Court held that this money was for support of the children. This court reverses and remands. The Tax Court clearly erred in finding that the payment was for support of the children. The agreement did not "fix" any amount for support of the children and that being lacking the entire amount is deductible as alimony. *Deitsch,* CA-6, 11/22/57.

Divorced father entitled to claim children living with wife [*Acquiescence*]. A father whose two minor children lived with his divorced wife is held entitled to the dependency credit for the children; the evidence as to the wife's income, the manner in which she lived, etc., convinced the court that the father had met the burden of showing that he furnished over half the children's support. *Cobb, Sr.,* 28 TC 595, *acq.* IRB 1957-49.

Student placed by school in "co-op" job for practical training may still qualify as dependent. A full-time vocational high school student may qualify as a student and therefore a dependent despite income over $600 even though, in accordance with his prescribed course of training, he is placed in a "co-op" job in private industry at certain specified intervals for practical training, and earns more than $600 on the job. Of course the parents claiming the student as a dependent must prove that they contributed over half of his support. *Rev. Rul.* 57-561.

Tax status of employees attending employer-organized school. An educational institute, owned and operated by a large industrial corporation, offered business and engineering courses related to the owner's operations. It had a permanent faculty, a regularly organized body of student-employees in attendance, and its credits were recognized by other institutions of higher learning. The IRS rules it is an "educational institution." Accordingly, an individual employed by the owner and attending classes at the institute on a plan calling for 24 weeks of study and 24 weeks of work may qualify as a "student" for purposes of the dependency exemption. Traveling expenses between the institute and the individual's place of employment are nondeductible personal expenses; amounts received by him from his employer while in training are not scholarships or fellowship grants but are taxable compensation. *Rev. Rul.* 57-484.

Policeman's $5-a-day expense allowance tax-free. After enactment of Section 120 in 1954, (which provided that "gross income does not include . . . a statutory subsistance allowance by . . . a police official" up to $5 a day), the Columbia, S. C., City Council passed an ordinance designating $5 a day of the policemens' salary as subsistance. The court holds the $5 a day received by taxpayer, a Columbia policeman, excludible. The language of both the Code and the local ordinance is clear. The court comments sympathetically that the purpose of the new Code rule was obviously to relieve the Federal overtaxation of policemen's meager incomes. *Shirah,* DC S. C., 10/4/57.

No deductible loss for "lost salary" while unemployed. In a *pro se* proceeding, taxpayer advanced the novel argument that he is entitled to deduct from his actual earnings an amount which he did not earn but contends he would have earned if he had been employed during every hour in which he could have been regularly employed. The court's reaction?—"theory is tenuous and has no support under law." *Bostick,* TCM 1957-220.

Lawyer's business expenses cut down; denied accumulated depreciation deduction. A lawyer's claimed deductions of $2,100 for club dues and expenses, $3,500 travel, $9,500 business promotional expenses at his residence, and $4,000 depreciation of a Cadillac, are partially disallowed for failure of proof. The court rejects the lawyer's arguments that his deductions were reasonable in view of his gross income of $61,000, and that similar amounts had been allowed in previous years. Taxpayer's claim of $4,000 depreciation was based on his failure to claim any automobile depreciation in prior years. The court

points out that depreciation cannot be accumulated but must be taken in the year in which it occurs. *Young,* TCM 1957-222.

Can't deduct imaginary quarters and subsistence. A U. S. Public Health Service officer while on leave without pay is detailed to a state that pays him only a salary. He cannot deduct an amount equivalent to the quarters and subsistence allowance he would have received had he remained on the Federal payroll. *Rev. Rul.* 57-536.

Sales promotion expense allowed in part. A sales manager of a corporation engaged in the distribution of coin-operated machines deducted between $4,500 and $7,000 in sales promotion expenses over a period of four years. Although a detailed record of the alleged expenditures was kept, no checks, receipts, or other documentary evidence was submitted. The court finds that the manager spent more than the $500 a year allowed by the Commissioner and determines a deduction of $2,000 each year by applying the *Cohan* rule. Since the Commissioner failed to prove that the taxpayer fraudulently "padded" his sales promotion expense deductions, no part of the deficiencies is held due to fraud. *Westerhaus Co.,* TCM 1957-213.

Corporate reimbursement to stockholder for alleged expenses taxed as dividend. Entertainment, Christmas, and picnic expenses paid by a corporation distributing coin-operated machines to a principal stockholder as reimbursement of expenses allegedly incurred by him on its behalf, are allowed as corporate deductions in amounts determined under the *Cohan* rule. The reimbursement in excess of the amount held properly deductible by the corporation is taxed to the stockholder as a dividend. *Westerhaus Co.,* TCM 1957-213.

Innocent liable for fraud penalty on joint return. A return signed in blank by taxpayer-wife and filed by the husband as a joint return subjects the wife to full tax liability including any additions for fraud, notwithstanding that all the income was earned by the husband and that she was innocent of her husband's fraud. The court added that it reached this conclusion with great reluctance, since the wife was a victim of the very fraud that brought on the assessment. *Funk,* 29 TC No. 32.

Transferee liability on gift from husband. Finding that the taxpayer's husband had gratuitously transferred $68,000 to her which did not constitute community property, the Tax Court held taxpayer liable as transferee for the husband's income taxes. This court reverses. The Commissioner had not overcome the presumption that all funds acquired after marriage are community property. *Santos,* CA-9, 6/28/57.

Grants to doctors by Mayo Foundation nontaxable fellowships. Grants and cost-of-living allowances received by medical doctors from the Mayo Foundation and Association while they are studying for graduate degrees at a clinic or hospital where they render no service, replace no salaried personnel, and perform no functions for the benefit of the grantor or training institution, are treated as fellowship grants and are excludable from gross income to the extent of $300 a month for 36 months as the Code provides. *Rev. Rul.* 57-560.

Jury finds strike benefit payments are gift. In a memorandum of instructions to a jury and its decision, in which few facts are given, the jury finds that certain payments received by taxpayer from the United Auto Workers union were gifts rather than compensation. Apparently, the payments were strike benefits to assist taxpayer's family during a strike. *Kaiser,* DC Wisc., 11/14/57.

Naval retirement pay for service nontaxable; disability is shown. Taxpayer voluntarily retired from the Navy in 1931 for reasons of age and length of service. He was recalled to active duty in 1941 and later released when found physically disabled. Upon release, he continued to receive pay allowances based upon his original retirement status. Since the allowances were not based upon "sickness or personal injuries resulting from active service," the Tax Court held the payments were not excludable as disability payments. This court reverses. It rejects a literal reading of the statute, holding that Congress must have intended not to tax payments received by a man released for disability even though he was also entitled to regular retirement payments. *McNair,* CA-4, 11/5/57.

Theological students taxed on amounts received while training as pastors. All amounts received by students of a theological seminary from a parish during the year they are required to serve as part-time or assistant pastors of the parish are compensation and cannot be treated as scholarship or fellowship grants. Since the students are not as yet ordained, they cannot exclude as parsonage or rental allowance the value of board and room furnished. *Rev. Rul.* 57-522.

Gain recognized on sale of old residence where new residence acquired more than year previously. Taxpayer bought a new house in October, 1952, and moved in in April, 1953. He didn't sell the old one until February, 1954. Section 1034 of the 1954 Code specifically requires that the new residence be both purchased and occupied within a year before or after the sale for the nonrecognition of gain. Since the purchase (1952) was well over a year prior to the sale (1954), taxpayer did not fully comply with this condition and gain on the sale of the old residence is taxable. *McCall,* DC Ala., 10/8/57.

Living and travel expenses on out-of-town jobs not deductible. Taxpayers were construction workers who worked at various job sites both near their home and at distant points. They attempted to deduct living expenses and transportation on costs at jobs away from home for periods of 8 to 20 months. The Tax Court recognized the particular job assignments as "temporary" and allowed the deduction. This court reverses. It finds the Tax Court was clearly in error in characterizing the jobs as "temporary," since each taxpayer had quit for undisclosed or personal reasons while work was still available. It holds the jobs were of indeterminate duration. *Peurifoy,* CA-4, 11/11/57.

Travel and subsistence allowed for worker in Greenland nine months. Taxpayer was a construction worker who maintained a home for his family in Oregon. During the taxable years in question he twice took work on military construction projects in Greenland. The first time the employment lasted for four months, the second time for nine months. The court finds that the term of the employment was temporary and holds that taxpayer's travel expense to Greenland and his living expenses while there are deductible as an ordinary and necessary trade expense. *Jennings,* DC Ore., 11/15/57.

NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

EDITED BY CARL M. ESENOFF, CPA, & C. W. LAMDEN, Ph.D., CPA

Planning to get full tax benefit from an operating loss deduction

by **GODFREY W. WELSCH**

A taxpayer with an operating loss needs careful tax guidance in order to make the best of it. Corporate dividend income and individual other income are perhaps the best-known areas in which poor planning can result in a taxpayer's "using up" his loss with no benefit. Mr. Welsch, CPA and partner in Lybrand, Ross Bros. & Montgomery, Dallas, reviews these and other hazards, considers briefly the computation of the deduction and points out the difficulties in trying to preserve carryovers through corporate reorganizations of various types.*

WE HAVE HAD a net operating loss relief provision for approximately 34 of the last 40 years of income taxation. The original concept was that only a taxpayer's true "economic loss" should be effective to reduce the taxable income of prior or subsequent years, and therefore adjustments were required to eliminate the tax benefits of other relief provisions from both the taxable year giving rise to the loss and from those years to which and through which it was to be carried. For example, a taxpayer was required to restore the excess of percentage depletion over cost depletion, to add back the corporation credit for domestic dividends received and to include 100% of capital gains in computing the net operating loss deduction and its effect on the taxable income of other years.[1]

The adjustments required to be made, and the number of years backward or forward a net operating loss could be carried have been the subject of frequent Congressional experimentation.

Under the 1954 Code, a net operating loss may be carried back two years and forward five years until exhausted. That is, it is carried first to the second preceding year, then to the immediately preceding year, then to the succeeding year, and so on. Thus, the effects of a disastrous business transaction can be spread over an eight-year period—the year in which the transaction occurred, the two preceding years and the five succeeding years.[2] Under the 1939 Code, losses for years beginning after December 31, 1949, can be carried forward five years. Therefore, we are still involved with losses from 1939 Code years, and will be through 1958, in the case of calendar year taxpayers.[3]

The theory that a taxpayer should receive benefit only from his true economic loss may seem sound at first glance—after all, why should a corporation or individual receive a tax break if the loss shown on the tax return results solely from the application of tax benefit sections of the law? But proponents of this theory lose sight of the fact that a basic purpose of the net operating loss deduction is to place the taxpayer with a fluctuating income as closely as possible in the position of the taxpayer with a level income. This cannot be done under the economic loss concept because the level-income taxpayer gets the benefit of all the tax relief sections while the taxpayer with the fluctuating income loses the benefit of these sections when he computes the economic net operating loss.

Although certain adjustments still have to be made under the 1954 Code, in computing the net operating loss and net operating loss carryovers and carrybacks, these adjustments are far less stringent than those required under the 1939 Code. To a large extent, the economic loss concept has been abandoned. In computing a net operating loss for any taxable year ending after December 31, 1953, no adjustment is required for the excess of percentage depletion over cost depletion, nor is a taxpayer required to add back wholly tax-exempt interest.[4]

Corporate taxpayers are allowed the the dividends received deduction in computing the net operating loss.[5] This leads to a strange quirk in the law. Ordinarily, the dividends received deduction is limited to 85% of the dividends received or 85% of the taxable income, whichever is smaller. Obviously, such a limitation would eliminate any dividends received deduction in a loss year. To solve this problem, Congress amended the section covering the credit for domestic dividends received to provide that the limitation does not apply if the taxpayer has a net operating loss for the year. In determining whether a taxpayer has such a net operating loss, the full dividend received deduction, without limitation, is used. A danger point exists where a small change in net income can result in a denial of a substantial deduction for dividends received.

Assume that a corporation has received $1,000,000 of domestic dividends. If the net income of that corporation, before the deduction for dividends received, is $849,900, the corporation is entitled to a full dividend received deduction of 85%, or $850,000 because such deduction results in a net operating loss of $100 and the limitation does not apply. However, if the net income of the corporation were increased $100 to $850,000, the allowance of the full deduction for dividends received would not result in a net operating loss. Therefore, the limitation would apply, the dividend deduction would be limited to $722,500 and the corporation would have taxable net income of $127,500. Thus, the addition of $100 more income would increase taxable net income by $127,600.

* This article is based on a paper presented at the Fifth Annual Texas Technological College Tax Conference in Lubbock, Texas.

[1] IRC Sec. 122(d); W. O. Allen, 22 TC 70.
[2] IRC Sec. 172(b)(1).
[3] IRC Sec. 122(b)(2)(B) (1939).
[4] IRC Sec. 172(d).
[5] IRC Sec. 172(d)(6).
[6] Montgomery's *Federal Taxes*, 36th Edition, pp. 7-34, 7-35.
[7] IRC Sec. 703(a)(2)(E).

Any corporation which has dividends received in excess of net income must make careful computations to see how close to the danger point it is and some cushion should be provided to guard against adjustments made by a revenue agent upon examination of the return. This can be done either by reducing the net income so that a net operating loss results or by increasing it to a point where the limitation does not apply by deferring deductions and accelerating income.[6]

Computation of deduction

Although the economic loss concept has been substantially abandoned by the 1954 Code, there are still certain adjustments which must be made in order to compute the net operating loss. One adjustment applies to all taxpayers, two adjustments apply only to corporate taxpayers and four adjustments apply to individuals, trusts and estates. No adjustments need be made by partnerships, because the net operating loss deduction does not apply to partnerships. A partner takes his share of partnership loss into account in his individual return. If this results in a net operating loss, it is the net operating loss of the partner and it can be carried back and forward subject to the rules applicable in each case.[7]

The starting point for the computation of the net operating loss is the loss shown by the return, i.e., the excess of allowable deductions over gross income. For purposes of computing such net loss, a corporation is allowed the full deduction for dividends received. The limitation of these deductions to 85% of taxable income does not apply. Similarly, the deduction for dividends paid on the preferred stock of a public utility is allowed in full.[8]

The one adjustment which applies to all taxpayers is that, in computing the net operating loss, no net operating loss deduction is taken into account. This provision is essential to prevent a net operating loss from being carried back or forward further than the prescribed period.[9]

A corporate taxpayer, in computing its net operating loss,, must add back the deduction for partially tax-exempt interest allowed by Section 242 and the special deduction allowed to Western Hemisphere trade corporations by Section 922.[10]

A noncorporate taxpayer, that is, an individual, trust, or estate, computes his net operating loss by adding back, first of all, any deductions for personal exemptions. If capital losses exceed capital gains, any excess is not deductible. If net long-term capital gains exceed net short-term capital losses, if any, the deduction for 50% of such excess must be added back. Nonbusiness deductions are allowed only to the extent of nonbusiness income. That is, if deductions not attributable to a trade or business of the taxpayer exceed gross income not attributable to a trade or business, such excess must be added back. In this connection it might be noted that the courts have held salary income to be business income.[11] Losses attributable to disposition of real or depreciable property used in the trade or business, i.e., Section 1231 assets, are deemed to be business losses but casualty losses are not.[12] Under the 1939 Code, the situation was just the reverse.[13]

The net operating loss deduction for any year, under the 1954 Code, is the sum of the net operating loss carryovers and carrybacks to such year.[14] In determining a net operating loss deduction under the 1939 Code, adjustments had to be made in the year of the loss, the year to which the loss was carried, and — for the purpose of determining how much of the loss had been used up in a prior year—in each year through which the loss was carried.[15] Frequently these modifications consumed the loss without tax benefit.

Under the 1954 Code, no adjustment is required to the incoime of the year to which a net operating loss is carried, but adjustments must be made to the income of any year through which a loss is carried for the purpose of determining how much of the loss is available for use in a later year. There are fewer of these adjustments than under the 1939 Code; they consist of adding back to taxable income some of the items discussed earlier. In the case of corporations these items are the deduction for partially tax-exempt interest and the special deduction allowed to Western Hemisphere trade corporations.[16] Other taxpayers add back the deduction for personal exemptions, the excess of capital losses over capital gains to the extent such excess was allowed as a deduction in computing taxable income, and the deduction for 50% of the excess of net long-term capital gain over net short-term capital loss.[17]

Planning use of losses

The foregoing is the statutory pattern of the net operating loss deduction. But merely knowing how to compute a net operating loss deduction is not enough. Taxpayers with net operating losses, and taxpayers on the borderline between a loss and a profit should make careful computations to determine whether to accelerate income and defer deductions, or vice versa, and thus shift income between years in order to attain the maximum possible tax benefit.

During the calendar year 1954 and fiscal years beginning in 1954, there was a great incentive to maximize a net operating loss since it could be carried back to an excess profits tax year. Noncorporate taxpayers, subject to tax at sharply graduated tax rates, may still have the same incentive to carry losses back to high-bracket years. Even though the corporate tax rate has not been changed for several years, it still might be advantageous to get back tax monies previously paid instead of deferring deductions for use against future income, which may never be realized. Another factor which must always be considered is whether the adjustments previously discussed will consume all or a substantial portion of a loss without tax benefit.

Assuming the effect of the required adjustments is not material, a taxpayer should take any available means to accelerate deductions and defer income, and thus increase the loss. Conversely, if the modifications would consume the loss, wholly or in substantial part, the taxpayer should strive to minimize the loss by accelerating income and deferring deductions.

When the period to which a loss may be carried is about to expire, i.e., the fourth or fifth carryforward year, taxable income should be maximized by accelerating income and deferring deductions. The income so accelerated will be realized tax-free because the net operating loss carryover, which otherwise would be wasted, will be utilized. The deductions which were deferred will offset income of later years. In this connection, it should be noted that, if a loss carryover can not be utilized in any other way, the basis of property can be stepped up tax-free. Although a tax-

[6] IRC Sec. 172(d)(6).
[7] IRC Sec. 172(b)(2)(B); Sec. 172(d)(1).
[8] IRC Sec. 172(d)(5).
[9] Anders I. Lagreide, 23 TC 508; E. G. Overly, 15 TCM 1044.
[10] IRC Sec. 172(d)(2); (3) and (4).
[11] IRC Sec. 122(d)(5) (1939).
[12] IRC Sec. 172(b)(2).
[13] IRC Sec. 122(C), (d).
[14] IRC Sec. 172(d)(5).
[15] IRC Sec. 172(d)(2) and (3).

payer cannot realize a deductible loss by selling stock or securities, no similar provision limits the recognition of a profit. That is, the "wash sale" provision only applies to losses.[18] Therefore a taxpayer can sell property which has appreciated in value and immediately repurchase identical property. The profit on the sale is not taxed because it is offset by the net operating loss deduction. The newly acquired property has a basis equal to its cost, i.e., the current high value. The sale and purchase can occur simultaneously, thus avoiding risk of market changes.

Corporations in liquidation

The fact that a corporation is in the process of liquidation has no effect upon the net operating loss deduction provided the corporation is in existence at least part of the loss year. While it is clear that "existence" means more than just legal existence, without form or substance, it is not clear how far liquidation may proceed before "existence" ceases. Therefore, corporations going out of business should be careful not to postpone deductions too long.[19]

While on the subject of the net operating loss of a corporation in liquidation it might be well to say a word about 1954 Code Section 337.[20] To avoid the *Court Holding Company* problem and eliminate the necessity of deciding whether property was sold by the corporation and the proceeds distributed to its stockholders or whether the property itself was distributed to the stockholders and then sold, Congress provided in Section 337 that if certain prescribed steps are taken, no gain or loss is realized when a corporation sells its property in accordance with a plan of liquidation.[21] If in connection with the termination of a business, the assets of the corporation will be sold at a loss, care should be taken *not* to comply with Section 337. Thus loss will be recognized upon the sale; and the net operating loss resulting from, or increased by, such sale can be carried back to recover taxes paid in the two preceding years. On the other hand, if the assets are going to be sold at a profit, the corporation should be careful to comply with Section 337. The gain, which otherwise might diminish a net operating loss, will not be recognized.

If some assets are to be sold at a loss and others at a profit, the corporation has a problem. It can sell the loss assets, then adopt a plan of complete liquidation, then sell the profit assets, and then hope for the best, in that order. The Treasury, however, may contend—perhaps successfully—that the plan was adopted informally before any assets were sold. Thus, the loss might not be recognized.[22]

Effect of individuals' losses

There are other sections of the Code which interact with Section 172, which provides for the net operating loss deduction. For example, a net operating loss carryback has an effect on the medical expense deduction and the child care deduction.[23] By reducing adjusted gross income, the carryback may serve to increase the amounts of these deductions. The standard deduction for individuals is based on adjusted gross income and must be recomputed in the event of a net operating loss carryback. Under the 1939 Code, the operating loss carryback deduction had to be taken into account in computing the percentage limitation on the deduction for charitable contributions. This is no longer the case under the 1954 Code.[24] However, a net operating loss carryforward deduction still must be taken into account for this purpose.

Consolidations and successors

The Regulations dealing with the filing of consolidated returns have many provisions governing the deductibility of net operating loss carryforwards and carrybacks by members of an affiliated group of corporations filing a consolidated return.[25] The manner in which net operating losses are carried from, to and through consolidated and separate return years is far beyond the scope of this paper. Obviously, however, any loss which is availed of to offset the income of an affiliated company in a consolidated return cannot be carried back or forward to reduce the loss corporation's taxes for other years.

The net operating loss deduction is allowed to all taxpayers, individual and corporate, with the exception of regulated investment companies and life and certain mutual insurance companies.[26] There are, however, two troublesome areas that must be resolved before it can be determined whether or not a particular taxpayer is entitled to a net operating loss. The first area for consideration is whether the taxpayer claiming the loss is deemed to be the same taxpayer as the one which sustained the loss. The second area for consideration is whether the specific loss in question is covered by one of the special limitation provisions of the Code.

Net operating losses sustained by a decedent during his lifetime cannot be carried over from the decedent to his estate since the decedent and his estate are separate tax entities. Similarly, a net operating loss of the estate is not available as a carryback from the estate to the decedent.[27] Likewise, a net operating loss sustained by a trust is not available as a carryback or carryover from the trust to a beneficiary of the trust. Under the 1954 Code, however, the net operating loss of an estate or trust, either sustained in or unused in its last taxable year, may be carried over by the beneficiary who succeeds to the property of such estate or trust.[28]

The big problem in the area of identity of taxpayer arises in connection with predecessor and successor corporations. Under the 1939 Code, there was no specific provision with respect to the allowance of carrybacks or carryovers to successor or predecessor companies. The deduction was allowed to the "taxpayer," and the question was whether the successor corporation in a corporate transaction was the same taxpayer as the predecessor corporation. Some courts sustained the Treasury view[29]—others held that under the laws of the state in which the reorganizations occurred, the corporation resulting from a statutory merger or consolidation was deemed to be the same entity as its components.[30]

On May 27, 1957, the Supreme Court handed down its decision in the *Libson Shops* case.[31] This case involved a taxpayer which was the surviving corporation in a statutory merger involving 17 corporations, all of which were owned by the same persons in the same proportions. Three of the corporations had net operating losses which the taxpayer sought to carryover to reduce postmerger income.

The Government's principal contention was that the corporation which sustained the losses was not the same corpo-

[18] IRC Sec. 1091.
[19] Winter & Co., Inc., 13 TC 108; Justice Motor Corp., 97 F. Supp. 570, Diamond A Cattle Co., 233 F.2d 739.
[20] IRC Sec. 337.
[21] Court Holding Company, 324 U.S. 331.
[22] IRC Sec. 337.
[23] IRC Sec. 213, 214.
[24] McDonnell Aircraft Corp., 16 TC 189.
[25] IRC Sec. 1501 *et. seq.*; Reg. Sec. 1.1501 *et seq.*
[26] IRC Sees. 803(c)(6)(C); 822(c)(8)(B); 852(b)(2)(B).
[27] IRC Sec. 7701(a)(14); R. R. Russell, 34 BTA 715.
[28] IRC Sec. 642(h).
[29] Standard Paving Co., 190 F.2d 330.
[30] Snider, 224 F.2d 165; Alprosa Watch Corp., 11 TC 240.

ration as the taxpayer which tried to deduct them. Thus, under the 1939 Code, the losses could not be carried over.

If the Supreme Court had accepted this argument, there would have been no great cause for alarm, even though there were decisions of lower courts to the contrary. Unfortunately, however, the Court based its decision on the Government's alternative argument that "the carryover privilege is not available unless there is a continuity of business enterprise." The Court said that "we conclude that petitioner is not entitled to a carryover since the income against which the offset is claimed was not produced by substantially the same businesses which incurred the losses."

Consider the situation where a corporation, with no change in the ownership of its stock, discontinues a line of business at which it is losing money and begins a new business which turns out to be profitable. Can the net operating losses arising from the old business be carried forward to offset the profits arising from the new business? In a footnote the Supreme Court noted that it was not passing on such a situation.

If the Supreme Court had based its decision on the Government's primary contention, *Libson Shops* would now be dead. Unfortunately, however, they announced the doctrine of continuity of business enterprise; and there is a possibility that the Service may attempt to apply this doctrine under the 1954 Code, especially when there has been a combination of corporations.

Successors under the 1954 Code

As the Court pointed out in the *Libson Shops* case, the 1954 Code deleted the troublesome reference to "the taxpayer." As a matter of fact, Section 381 of the 1954 Code provides that under certain circumstances, one corporation may succeed to the net operating loss carryover of another corporation.[32] Generally speaking, such succession is permitted when one corporation acquires all or substantially all of the assets of another corporation in a tax-free reorganization. In all, there are 19 attributes, ranging from earnings and profits to contributions in excess of the deductible limit, as to which the acquirer steps into the transferor's shoes under Section 381.

The first transaction, as a result of which the acquirer takes over the transferor's tax attributes, is the tax-free liquidation of an 80%-or-more-owned subsidiary.[33] Succession does not occur, however, if the basis of the assets received in liquidation is determined with reference to the parent's basis for the stock of the subsidiary, under 1954 Code Section 334(b)(2). This exception is necessary in order to prevent a corporation which has purchased the stock of another corporation in order to get its underlying assets, from getting such corporation's net operating losses as well as a stepped-up basis for the underlying assets. The second transaction in which the acquiring corporation takes over the predecessor's net operating loss carryovers is a statutory merger or consolidation. Succession also is permitted when one corporation, in exchange solely for part or all of its voting stock, acquires substantially all the assets of another corporation.[34]

If a reorganization merely effects a change in the identity, form, or place of incorporation, the acquiring corporation naturally succeeds to the 19 tax attributes.[35] For example, if a corporation moves its state of incorporation from Delaware to Texas, the Texas corporation—which technically is a new entity—can use the Delaware corporation's net operating loss carryover. In this last case, net operating losses can be carried back and forward just as if no change had occurred. In all other cases, the acquirer's losses can not be carried back to obtain refunds of the predecessor's taxes. For this reason, if postacquisition losses are expected, the corporation which paid the largest taxes generally should be the survivor. In addition there are technical restrictions on the use of carryovers.

Naturally, the predecessor's net operating loss should not be applied to income earned by the successor prior to the time when it acquired the predecessor's assets in one of the transaction's previously described. In order to prevent this, Congress has made the arbitrary, but necessary, assumption that the successor's taxable income was earned ratably over its taxable year. The net operating loss carryover from the predecessor to the successor's first taxable year ending after the acquisition of assets is limited to the portion of the successor's taxable income for such year which is deemed to have been earned after such date. For example, if the successor corporation's taxable income for the calendar year 1957, determined without regard to the predecessor's net operating loss, is $365,000, and if the acquisition of assets occurs on October 31, 1957, the net operating loss deduction can not exceed $61,000. Thus, tax has to be paid on at least $304,000. If the carryover exceeds $61,000, the excess may be used in subsequent years.[36]

The rules governing the manner in which the net operating losses of the predecessor and/or successor corporation are carried over, and the year to which they may be carried, are quite complex. To make matters worse, no Regulations have as yet been promulgated under Section 381. The Senate Finance Committee Report is a reasonably good guide to the purpose and intent of this section; but it will probably be many years before Regulations, court decisions and additional legislation clear up troublesome points.[37]

Trading in loss corporations

The second area of difficulty in determining whether or not an operating loss may be used, arises in connection with the special limitations contained in the Code.

For many years there has been trading in loss corporations. Congress was troubled by the fact that people were buying loss shells, putting profitable businesses into them, and thus realizing tax-free income. To stop this practice, as well as other tax avoidance practices, Congress enacted 1939 Code Section 129. This section provided in effect, that if the principal purpose of acquiring control of a corporation or its assets was the avoidance of Federal income tax through obtaining the benefit of a deduction, credit, or other allowance, which the acquirer would not otherwise enjoy, then such deduction, credit, or other allowance would be disallowed. Until very recently, the Treasury had no success under Section 129, because the courts held that the principal purpose of the acquisition was something other than the condemned tax avoidance purpose.[38] Moreover, although the language was *dicta*, in one case the Tax Court said that the section did not apply so as to disallow the deduction under the

[31] Libson Shops, Inc., 229 F.2d 220.
[32] IRC Sec. 381(c)(1).
[33] IRC Sec. 332.
[34] IRC Sec. 361.
[35] IRC Sec. 381(c).
[36] IRC Sec. 381(c)(1)(B).
[37] S. Rept. 1622, 83rd Congress, 2d Session, 275 *et. seq.*
[38] Alprosa Watch Corp., 11 TC 240; Alcorn Wholesale Co., 10 TC 75; Berlands, Inc., 16 TC 182.
[39] Coastal Oil Storage Co., 242 F.2d 396.
[40] S. Rept. 1622, *supra.*
[41] House Rept. 2543, 83rd Congress, 2d Session, 40.
[42] Spreckels Sugar Co., 137 F. Supp. 750.
[43] IRC Sec. 6164.
[44] IRC Sec. 6411.

circumstances previously mentioned, because the loss corporation had the deduction by reason of its previous losses, not because of the acquisition. Some tax men, most of whom were employed by the Government, seized upon the word "benefit" and said that the corporation may have had the loss carryover, but it would have derived no benefit from it unless the corporation's stock had been acquired and a profitable business put into it. No court has, so far, adopted this theory as it applies to net operating losses; but in a recent decision, the Fourth Circuit applied the derived-benefit theory to prevent a newly created subsidiary from enjoying the $25,000 surtax exemption.[39]

When Congress passed the 1954 Code, it re-enacted Section 129 as Section 269; and to put some teeth into the section, it added a presumption. Under this presumption, which is contained in Section 269(c), if the purchase price of the loss corporation's stock is disproportionately low compared to the tax basis of the corporation's assets and its other tax benefits, it is presumed that the principal purpose of the acquisition is tax avoidance. However, the presumption can be overcome by evidence that a business purpose was the principal motivation for the acquisition.

In addition to the general rule of Section 269, Congress provided two mechanical rules in Section 382.

Section 382(a) limits the use of net operating losses under certain circumsances even though only one corporation is involved. It was designed specifically to prevent people from buying the stock of a loss shell, that is, a corporation with no assets except net operating loss carryovers, putting a profitable business into it, and realizing tax-free income. Thus, if 50% of the stock changes hands within a period of two taxable years, and if the corporation does not continue to carry on a trade or business substantially the same as that conducted before any change in the ownership of the stock, the net operating loss carryovers are disallowed. The 50% change in ownership can result from a purchase of stock, from a redemption of stock by the corporation, or a combination of the two. This test rarely will be met by widely held corporations or inadvertently, because only the ten largest stockholders are taken into account for the purpose of determining how much stock was acquired during the two-year period.

It will be noted that the losses are not disallowed if the corporation continues to carry on a trade or business substantially the same as that conducted before the change in ownership. What this means, however, no one knows. Suppose, for example, that the old business is continued, but a new line is added. Is the test met *per se*? Does the question turn upon the relative size of the businesses? Can any number of new businesses be added, so long as the old one is continued?

The Senate Finance Committee Report[40] tells us that the condition is met if "the corporation shifts from one type of business to another, discontinues any except a minor portion of its business, changes its location, or otherwise fails to carry on substantially the same trade or business." The Conference Report[41] states that if the corporation continues to carry on substantially the same business the limitation would not be applicable even though the corporation added a new business.

It should be fairly easy to tell whether a business has been discontinued. Shifts in type of business may be more troublesome. Suppose, for example, a corporation surrenders its Ford franchise and starts selling Edsels. It is still in the automobile business, but it is not in the Ford business. Is this a prohibited shift in type of business?

Change in location

Change in location presents another difficult problem. Possibly, if a downtown barber shop moves out to the suburbs, it may be deemed to have changed its business because it has a different group of customers. But if General Motors were to close its Detroit plants and thereafter do all of its manufacturing in Texas, this should not be held to be a prohibited change in location because its market would still be nationwide.

Section 382(b) applies to reorganizations covered by Section 381. Section 382(b) applies to reorganizations whether the loss company goes out of existence or not. It can not be avoided by using the loss corporation as the surviving vehicle. Speaking generally, Congress has provided that, in order to retain full benefit of any net operating loss carryovers, the owners of the loss corporation must come out of the reorganization owning at least 20% of the surviving corporation's stock. For each percentage point less than 20 that they get, the carryovers are scaled down 5%. Thus, if the owners of the loss corporation get only 7% of the stock, 65% of the losses is disallowed.

Section 382(b) only applies to net operating loss carryovers. Thus, if a corporation has losses in the early part of the year, and a profitable corporation is merged into it, the premerger losses can be offset against postmerger income.

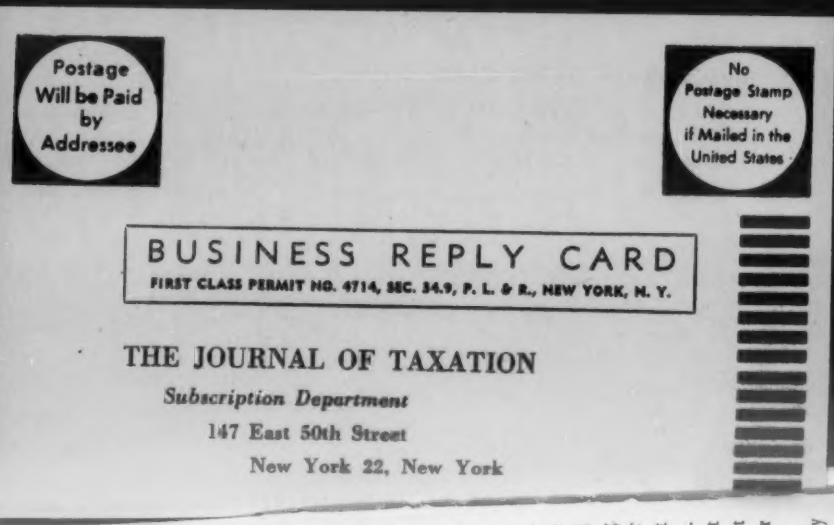
In addition to the statutory prohibitions against the use of the net operating loss deductions, there are at least two court cases which must be kept in mind. The first of these, the *Libson Shops* case, has already been discussed. The second case to consider is the *Spreckels Sugar* case.[42] In this case, the Spreckels Sugar Company purchased the stock of a corporation shortly before it sold a substantial portion of its assets at a loss, in order to take advantage of this loss in a consolidated return. The Tax Court disallowed the deduction, saying that where the only purpose of acquiring the stock was to get the loss, the loss would not be allowed as a deduction.

Other loss problems

There are numerous other points that may be mentioned in connection with the net operating loss deduction. For example, the question sometimes arises as to whether a corporation's utilization of its net operating losses would be affected by the fact that it went into receivership. Since only one taxable entity is involved, it should be possible to carry losses to and from the receivership period.

Section 172 also interacts with Section 7121, which deals with closing agreements. If a taxpayer has entered into a closing agreement fixing the tax liability for a taxable year, that is the end of it. A refund can not be obtained as a result of carrying a net operating loss back to such year. On the other hand, such a closing agreement does not fix the amount of income for such year. The taxpayer still may prove a net operating loss for the closing agreement year, in order to obtain a carryback or carryover to some other year.

The net operating loss provision may have far-reaching effects. Working capital may be obtained under the provision allowing a corporation which expects to have a net operating loss to defer paying its taxes for the previous year.[43] Working capital also may be obtained by securing a "quickie" refund by applying for a tentative carryback


Postage
Will be Paid
by
Addressee
No
Postage Stamp
Necessary
if Mailed in the
United States
BUSINESS REPLY CARD
FIRST CLASS PERMIT NO. 4714, SEC. 34.9, P. L. & R., NEW YORK, N. Y.
THE JOURNAL OF TAXATION
Subscription Department
147 East 50th Street
New York 22, New York

SUBSCRIPTION ORDER CARD

258

To: The Journal of Taxation
147 East 50th Street
New York 22, New York

(for new subscriptions only—renewals are handled automatically)

Gentlemen: Please enter my subscription to The Journal of Taxation for one year at $15. I understand that my money will be refunded at any time for the unexpired portion of my subscription if I am not completely satisfied. check enclosed ☐ bill me ☐

name .....

firm ..... title .....

street .....

city ..... zone ..... state .....

I am a lawyer ☐ CPA ☐ PA ☐ other tax practitioner ☐

(please specify) .....

adjustment.[44] Both of these provisions may affect management's decisions on matters of financial policy.

These same provisions may affect labor-management relations. Losses resulting from a strike can bring refund of prior years' taxes. This may encourage management to hold out longer. On the other hand, it may reduce the cost of granting expensive, but short-lived benefits.

In closing, I should like to point out that, when taxpayers start dealing in loss corporations, they should keep one eye on Section 172, one eye on Section 269, one eye on Section 381, one eye on Section 382, one eye on *Libson Shops,* and one eye on *Spreckles Sugar.* Adding up the eye requirements for doing the job properly, you will find that you need six eyes. This logically implies three heads. As to this, all I can say is that you don't have to have three heads to be a tax man—but it helps! ☆

Propose accelerated depreciation on used property

ONE PROVISION of the current Code that came in for considerable criticism at hearings before the Senate Committee on Small Business is the denial of accelerated depreciation methods to equipment purchased second-hand. Hans H. French, Coral Gables, Florida, CPA, pointed out the harsh workings of the rule. He said, in part: "Section 167 of the 1954 Code as amended should be broadened to include 'used' property.

"With the trend for higher replacement costs, the notion that a piece of used equipment is considerably lower in price and has a vastly shorter life than the same equipment when purchased new has often proved a fallacy.

"For example, one of my clients contemplated the acquisition of a small warehouse, about three and one-half years old, for an amount in excess of $75,000. Being short of working capital, this purchase, based on fairly short-range financing, seemed an ideal way to maintain an adequate cash balance for business purposes, assuming an accelerated method of depreciation, particularly during the first few years of operation, could be used.

"When informed that his contemplated purchase, because of the 'used' condition would not qualify under Section 167, the client was forced, because of pressing space problems to acquire a new structure, at approximately the same price, subject to long-range financing, but operationally far less suited to his purposes.

"It should be possible for a businessman to weigh the advantages or disadvantages of the acquisition of a particular piece of machinery or equipment of whatever nature it may be, solely by consideration of adequacy for his enterprise, rather than be influenced by the tax impact such as is now presented in the differentiation between 'used' and 'new,' as required by the Code.

"There is no valid reason why simple yardsticks governing the taxability of such an investment cannot be provided by the Code. As a matter of fact, they are provided now by the requirement that the anticipated life of the item subject to accelerated depreciation must be in excess of three years.

"In particular, Section 167(c)(2) should be revised to allow the methods provided in 167(b) to apply to 'new' as well as 'used' property, subject to such limitations as would be deemed in the best interests of taxpayers and Treasury Department alike." ☆

IRS insists subscriptions are income when received

REVENUE SERVICE men have confided to practitioners at a number of tax meetings this past autumn that the IRS "doesn't like" the *Beacon Publishing* decision (218 F.2d 697 (CA-10)). Now we see a major case docketed in the Tax Court which indicates that the IRS not only "doesn't like" *Beacon* but won't follow it.

In *Beacon* the Tenth Circuit followed what is generally considered to be sound accounting practice in allowing a newspaper publisher on the accrual basis to report prepaid subscriptions as income ratably over the subscription period.

The publishers of *U. S. News and World Report* are contesting a $950,000 assessment of income and excess profit taxes for the years 1952 to 1954 (Docket 70738).

The typical problem of a publisher is, of course, that if he sells subscriptions for a year in advance, say in June, he has a contractual obligation to render service for the next 12 months. His costs of fulfilling his contract are spread evenly over the 12 months. Good accounting practice would defer to the following year that portion of the subscription price corresponding to the unfulfilled portion of the contract, i.e., a subscription sold for $12 in June, commencing with the July issue, would "earn" $6 in the six months to the year-end. The remaining $6 would be in respect of a product produced, costs incurred, and delivered in the following taxable period; thus $6 should be deferred income, not to be taken into taxable income in the current period.

This question is of importance not only to publishers but also to all taxpayers who receive prepayments. In a case involving a dancing school (*Andrews,* 23 TC 1026) the Tax Court specifically refused to follow *Beacon* and required that the taxpayer (which was on the accrual basis) include in income its receipts for lessons to be given after the end of the year. ☆

New accounting decisions this month

Leasehold improvements depreciable over term of lease, not estimated life. A partnership made improvements to property leased from some of its partners and deducted the cost over the term of the ten-year lease. The Commissioner computed depreciation on the longer life of the improvements, contending that in effect the lease was for an indefinitely renewable tenure because of the close relationship between the parties. However, the court upholds the taxpayer, pointing out that there is no precedent for the principle that a lease with a specified expiration date, and no renewal option, becomes indefinite merely because the lessee and lessor are related, particularly where it is a fact that the lease would have been a fair one if made at arm's length between strangers. *Goldstein,* TCM 1957-218.

Change from declining balance to straight line on old property requires permission. For new or used property acquired prior to 1/1/54, and for used property acquired after 12/31/53, a change from the declining balance method of computing depreciation to the applicable straight line rate cannot be made without the Commissioner's

I am a lawyer ☐ CPA ☐ PA ☐ other tax practitioner ☐ (please specify)
city ..... zone ..... state .....
street .....

consent. [These categories are not eligible for 200% declining balance methods from which changes may be made to straight line without permission; they are eligible for the 150% declining balance method under the 1939 Code.—*Ed.*] *Rev. Rul.* 57-510.

Indians pay no tax on income from trust allotment lands. All income, including that from farming, grazing and an oil lease bonus, derived from land held in trust for Indians under an 1877 statute has been held tax-exempt. It follows that income received by an Indian, though of mixed blood, who is a member of the Mandan, Hidatsa, or Arikara Indian tribes, from lands held in trust under this act is exempt from tax whether the land was allotted directly or inherited. However, income from trust allotment lands rented from another Indian would be taxable. *Rev. Rul.* 57-523.

Improved property not "replacement" for unimproved property involuntarily converted. Unimproved property held by taxpayer for purposes of erecting warehouses thereon for rental was condemned, and the proceeds were timely invested in three parcels of improved realty also held for rental. The court holds the improved property is not "similar or related in service or use" to the unimproved converted property so as to entitle taxpayer to nonrecognition of gain on the conversion. A mere replacement of rental income property with other rental income property is not enough. *Steuart Bros., Inc.*, 29 TC No. 41.

"Forced" sale of stock rights not an involuntary conversion. A domestic corporation received stock rights to subscribe to shares in a foreign corporation, but the foreign corporation announced it would not accept subscriptions from U. S. residents because the stock was not registered with the SEC. The domestic corporation thereupon sold the rights. This does not constitute an involuntary conversion of property. There was no theft, seizure, or requisition, or condemnation or threat or imminence thereof. *Rev. Rul.* 57-517.

Stock received from qualified plan has an average cost basis. The trustee under a qualified profit-sharing plan had purchased stock of the employer at different prices in different years, and allocated the shares annually at an average cost to the individual accounts. The IRS rules that all shares distributed have an average cost basis for purposes of determining gain or loss on any later transaction. *Rev. Rul.* 57-514.

Annuity exclusion constant even though monthly payments increase. The amount to be excluded from the gross income of an annuitant who determines the excludable portion by an exclusion ratio is determined by dividing the total cost over the expected period of return. This exclusion remains the same even though the monthly payments are increased after the annuity starting date. *Rev. Rul.* 57-508.

Remainderman's basis is not value when life tenant dies. Taxpayer here acquired certain stock upon the death of his aunt (in 1946) who had a life interest in it under the terms of the will of her husband who had died in 1912. When taxpayer sold the stock in 1949, the Commissioner asserted its basis was the 3/1/13 value, not, as taxpayer claimed, 1946 value. The court upholds the Commissioner. *Brandeis,* DC Neb., 6/19/57.

Securities purchased with corporate funds not property of corporation. Taxpayer was sole stockholder of a corporation engaged in the stock brokerage business. It carried individual accounts in her name and the names of members of her family. While corporate funds were used to purchase securities for these accounts, the cost was charged to the individuals and the securities held as collateral for the debt. No charges were made by the corporation for servicing the accounts. The court holds the dividends, profits and losses, credited to these accounts belonged directly to the individuals rather than to the corporation and were therefore not to be considered as income of the corporation and dividends when distributed. The court says that when full details of transactions are disclosed and there is nothing to indicate deception, the burden of proving that the facts are other than they appear falls on the Commissioner. *Bass & Co.,* TCM 1957-208.

CAPITAL GAINS VS. ORDINARY INCOME

Payments for patent were part royalty, part compensation. Taxpayer was the founder of a corporation whose business was built on discoveries he had made and patents he held. At the request of a creditor of the corporation, taxpayer assigned certain patents owned by him to the corporation. The assignment agreement provided for a royalty of 8% to taxpayer with a reduction to 5% when taxpayer retired as executive head of the corporation. Although taxpayer argued that he performed no substantial services to justify compensation, the court finds the intent at the time of the assignment was that the price to be paid for the patent was a 5% royalty, taxable as capital gain. The additional 3% was intended as compensation for personal services. *Spence,* Ct. Clms., 12/4/57.

Royalty for sand removed is capital. Taxpayer owned land too steep to build on. It could be used only for residential purposes, and since it contained deposits of commercially valuable black sand, he contracted with a construction company to remove a fixed quantity of sand at a fixed price and leave the land graded. This court, reversing the Tax Court, finds the transaction a sale resulting in capital gain. The taxpayer transferred all his interest for a fixed sum [plus grading service] not dependent on production. *Gowans,* CA-9, 6/17/57.

Capital gain on real estate dealer's sales of inherited real estate. Taxpayer, who was in the real estate business, inherited some real estate. He sold the parcels at a profit. The court finds that he was merely liquidating an inheritance; these parcels were not held for sale in the ordinary course of business. The profit is therefore capital gain, not ordinary income. *Scott,* DC Neb., 10/7/57.

Capital gain on sale of unsubdivided part of a tract of land. A taxpayer who sells an unsubdivided part of a tract of land, a part of which was subdivided into lots for sale, is not in the business of selling real estate as to the unsubdivided part, and the sale thereof constitutes a sale of a capital asset. *Rev. Rul.* 57-565.

Employee subdividing homestead finds himself in real estate business. Taxpayer, a cashier in a meat market, acquired 11.55 acres of property under a patent granted by the Territory of

Hawaii. He erected a house and rented out portions of his land as vegetable farms. When the character of the neighborhood changed, he engaged a licensed real estate broker to subdivide the property and make improvements. Sales of the subdivided lots were held by the Tax Court to result in ordinary income. This court affirms. *Achong*, CA-9, 6/25/57.

Subdivided property held for sale to customers; gain is ordinary income. Taxpayer made certain improvements on property which he subdivided, and sold the entire property in six separate transactions. The Tax Court found that the property was held for sale to customers in the ordinary course of business and that the gain was thus capital gain. Since the question presented is purely one of fact, and the Tax Court's opinion is not clearly erroneous, this court affirms. *Peebles*, CA-4, 11/7/57.

Ordinary income on sale of lots upon liquidation of plantation. Between 1923 and 1926, taxpayer acquired property which she operated as a sugar plantation up until 1936, when the land was rendered worthless for farming. Thereafter two or three people came to her to buy building sites and she sold small tracts to them. In 1939, she began to plat and subdivide areas of land. Between 1949 and 1953, she sold 233 lots in 130 sales. Sales of these lots are held to result in ordinary income, since the facts were more indicative of an active business operation during the five-year period 1949-1953, than a passive and gradual liquidation of a capital asset over the 15-year period 1939-1953. Two dissents. *Barrios Estate*, 29 TC No. 42.

Ordinary income on pelts sold from breeding herd. Gain on sale of pelts periodically obtained from fur-bearing animals which have been held for breeding purposes for 12 months or more is not capital gain under Section 1231 (sale of livestock held for breeding). It is ordinary income realized from sale of property held primarily for sale to customers in the ordinary course of a trade or business. *Rev. Rul.* 57-548.

Ordinary income on demonstrator autos; capital gain on service pick-up trucks [*Acquiescence*]. Taxpayer, an auto dealer which sold new and used cars and trucks, assigned new cars to its officers, department heads, and salesmen primarily for the purpose of displaying and demonstrating them to the public. It was the dealer's practice to replace the cars with new cars as soon as new models were received, and in any event when they had run 15,000 miles. Capital gains treatment is denied on gains realized from the sale of such demonstrator cars; the cars were assigned only temporarily to use in the business and the assignment was at all times conditioned upon their withdrawal after a comparatively short period in relation to their useful life. Capital gain treatment is, however, allowed on sale of pick-up trucks used in the service department from 2½ to 4 years, since they were generally withdrawn from stock-in-trade for an indefinite period and committed to use in the ordinary operations of taxpayer's business. *Duval Motor Co.*, 28 TC 42, *acq.* IRB 1957-45.

Assignment of lease a sublease, not a sale. Taxpayer here held a 99-year lease on property. It proposed to "sell" this lease, reserving to itself an option to purchase. The IRS rules, however, that the amount to be paid by the "purchaser" for the assignment will be advance rentals and reportable as ordinary income. The facts indicate that the assignment was in the nature of a sublease rather than a sale. It is generally considered that a transfer by a tenant of less than his full interest is a sublease and the intent of the parties here is to achieve a sublease not a sale. *Rev. Rul.* 57-537.

DEDUCTIBILITY

Payments to fulfill option contract were really interest. Taxpayer had an option to buy certain stock. A family corporation actually bought it and gave him an option to buy it (apparently after inherited funds would be available to taxpayer). Taxpayer guaranteed the corporation against loss and that it would have a certain income; should the income be higher the excess would reduce taxpayer's option price. Actually its income fell below the guaranty and taxpayer paid the difference and claimed it as interest. The district court found this was additional purchase price of the stock. As taxpayer was not indebted to the corporation, he could not incur interest. This court reverses in one of the rare decisions in which the taxpayer successfully invokes the form v. substance argument. It finds the substance of the transaction was a loan by the corporation. The risks of ownership were on the taxpayer at all times. *Patton*, CA-7, 11/5/57..

Restrictive covenant, separately bargained for, amortizable over its life. Taxpayer negotiated for the purchase of a dry cleaning business. A covenant by the seller not to compete was particularly sought by taxpayer. It was dealt with as a separate item; its duration and the consideration to be paid for it were the subject of bargaining between the parties; and its provisions were more severe than those of covenants not to compete usually made in connection with the sale of similar businesses. The court holds the taxpayer may properly amortize the cost of the covenant. However, taxpayer cannot use a "declining" useful life, but must deduct one tenth in each year of the ten-year term. *Andrew Newman, Inc.*, TCM 1957-224.

May deduct cost of protecting stock investment in bankrupt railroad [*Acquiescence*]. Taxpayer, a closed-end investment corporation, acquired more than half of the old common stock of Missouri Pacific Railroad at a cost of $40,000,000. A few years later the railroad underwent a reorganization under the Federal Bankruptcy Act. Various plans of reorganization were proposed which would have wiped out taxpayer's common stock interest. Finally a plan was approved and adopted which gave recognition to the value of the common stock. Legal fees and other costs incurred by taxpayer in opposing the original reorganization plans and in proposing the plan which was finally adopted are held to have been made only to protect taxpayer's investment and are therefore deductible as ordinary and necessary business expenses. *Alleghany Corp.*, 28 TC 298, *acq.* IRB 1957-49.

Corporation can deduct expenses of stockholder suit it was forced to pay. A minority stockholder instituted a suit against taxpayer-corporation and its officers and directors "on her own behalf and on behalf of all other stockholders similarly situated" to enjoin the issuance and sale of certain Class B stock which, if carried out, would vest all control of the corporation in one family. The district court enjoined the corporation from issuing the stock and directed it to pay the litigation expenses incurred. Such expenses are held deduct-

ible by the corporation as ordinary and necessary business expenses. *Shoe Corp. of America,* 29 TC No. 33.

Cost of preparing catalog not deductible in year incurred. The costs during 1951 and 1952 of preparing a catalog which wasn't published until 1953 are considered capital items rather than deductible expenses for 1951 and 1952. It was shown that the catalog was used until 1956, when it was revised, and the original plates were used again, and were available for further use. The court holds merely that the deductions were not proper in 1951 and 1952. It had no occasion to determine when they would be deductible. One judge dissents. He would follow *Sheldon,* 214 F.2d 655, which, reversing the Tax Court, held that preparation of a catalog was similar to advertising and the costs could be deducted as incurred. *Best Lock Corp.,* 29 TC No. 43.

Additional royalties for improvements were voluntary and not deductible. An inventor of locking devices caused one of his controlled corporations, which held his patents, to grant taxpayer, also controlled by the inventor, a license to manufacture a lock together with rights to all amendments and improvements. In a later year, another corporation controlled by the inventor granted taxpayer a license to manufacture an improvement in the lock in return for additional royalties. The court finds that the improvement was available to taxpayer under the original license without payment of the additional royalties. Accordingly, the payment was voluntarily made without consideration and was not deductible by taxpayer as an ordinary and necessary business expense. *Best Lock Corp.* 29 TC No. 43.

"Confiscation" of equipment not a loss deduction. A distributor of coin-operated machines is not permitted a claimed loss for seizure or "confiscation" of machines by police officials. No evidence was presented that the machines were destroyed or that they could not have been recovered had steps been taken to do so. *Westerhaus Co.,* TCM 1957-213.

Farm boat repair deductible. Taxpayers used a ferryboat in hauling farm products as part of their dairy operation. From time to time the floor of the boat needed repairs. "It is the view of the court that this expenditure is comparable to the repair of a fence on a farm, and anyone who has ever lived on a farm knows that a fence is almost always in need of repair." It is deductible as an operating expense, rather than as a capital expenditure. *French Broad Ice Cream Co.,* DC Tenn., 9/9/57.

Compromise payment in litigation involving machine is cost of machine. Taxpayer, an envelope manufacturing corporation, engaged a contractor to rebuild and reconstruct a paper machine. The original contract was modified from time to time, and a controversy arose as to the exact amount due under the contract. Negotiations were carried on culminating in a compromise payment of $98,000 in settlement of a lawsuit begun by the contractor. This payment, together with legal fees and expenses incurred in connection with the litigation, are held to be capital expenditures increasing the cost of the machine, not deductible business expenses. *American Envelope Co.,* 29 TC No. 34.

Full year's real estate tax deductible by seller. (Old Law). After an extensive examination of Wisconsin law, the court concludes the assessment date for Wisconsin real estate taxes is May 1, although the levy is not made until December. Thus, when the taxpayer sold his property in June he is entitled, under prior law, to deduct the full year's taxes although half was apportioned to the buyer at the real estate closing. [1954 Code Section 164(d) now requires that the deduction for real estate taxes of the year of sale be apportioned between buyer and seller.—*Ed.*] *VanDyke,* DC Wisc., 11/1/57.

Annuity payments were capital expenditures for equipment. Taxpayer, on taking over an oil distributorship agreed to pay the previous distributor $250 a month for his life (or while the distributorship lasted). Taxpayer was to receive certain assets used by the annuitant in the business, title to pass in two years. The court holds that the monthly payments are a capital expenditure. Taxpayer's contention that the payments were partnership distributions is rejected in the absence of anything in the agreement pointing to the creation of a partnership with the lessee. The court notes that the excess of annuity payments over the value of the machinery are for the acquisition of a non-depreciable intangible. *Gant,* TCM 1957-216.

Ship chandler can deduct rebates. The court finds that the custom of ship's chandlers paying a rebate of 5% to the officers of the ship on all purchases by them for the ship is so ancient, widespread and well known that it is an ordinary and necessary expense of the chandler and in no way violates public policy. *Flambolis,* DC S. C., 6/21/57.

OTHER DECISIONS

Sale price as scrap used to determine loss in value for prior year. Taxpayer had been engaged in maufacturing dishwashers. He deducted for a loss in value of parts (apparently in inventorying them). The court upheld the figure at which the parts were reported, finding that the salvage value of the assets as computed by taxpayer at the end of the taxable year was substantially the same as the amount realized upon their subsequent sale as scrap. *Brubaker,* TCM 1957-186.

Bad debt denied even after petition filed under Bankruptcy Act [*Acquiescence*]. In 1947 taxpayer lent a related corporation $175,000 on long-term 5% notes. On 8/18/49 the borrower filed a petition for reorganization under the Bankruptcy Act. Taxpayer was denied a deduction for partial worthlessness of the notes for its fiscal year ended 8/31/49 on the ground that the borrower's statements at that time did not show it to be insolvent. However, the business situation so deteriorated during taxpayer's fiscal years ended 8/31/50 and 8/31/51 that the taxpayer is held entitled to ordinary-loss deduction for worthlessness of the notes in those years. *Bullock,* 26 TC 276, *acq.* IRB 1957-41.

Reasonable addition to bad debt reserve allowed shoe repair business. A shoe repair materials business based the additions to its bad debt reserve upon monthly additions computed at ½ of 1% of monthly sales. Although the Commissioner disallowed all additions to the reserve, the court, after noting that there was a depression in the shoe repair industry, finds on the basis of the *Cohan* rule that a reasonable addition to the bad debt reserve for each of the taxable periods should have been 3/10 of 1% of total sales. *Funkhouser Industries, Inc.* TCM 1957-197.

RR may have loss on abandonment of facilities. The IRS had previously ruled, GCM 21171, that a railroad is entitled to an abandonment loss for property discarded in connection with construction projects, even though the cost of the new construction is born in part by the state or the Federal Government. It now considers the application of this rule to property abandoned by two different railroads. In the first case, a railroad as part of a grade-crossing-elimination program abandoned a through-the city line and improved one around the city. Here, the IRS rules, the property abandoned and the new construction were sufficiently different not to be an exchange of like properties. The railroad is entitled to the abandonment loss; the contributions to the new construction are not income, under the rule of *Cuba Railroad Co.*, 268 U.S. 628, which held that subsidies were capital contributions, not income. In the second situation, the railroad owned property which would be flooded after the erection of a proposed dam. It agreed to accept, in lieu of damages, the construction of embankments, a bridge, etc., and other new facilities in place of those to be abandoned. This, the IRS rules, would be an exchange of like properties and tax-free. *Rev. Rul.* 57-450.

Card-punching machine worthless prior to year of claimed abandonment [*Certiorari denied*]. Taxpayer who had patented a card-punching machine claimed an abandonment loss for the patent in 1949. The Tax Court concluded that the invention was obsolete and worthless prior to 1949, therefore the loss to worthlessness was not deductible in 1949. The Eighth Circuit affirmed. The issue is one of fact and the finding of the Tax Court is supported by the evidence. *Meyer, cert. den.* 10/28/57.

Operating loss not reduced by EPT refund arising from its carryback. In computing an operating loss carryover, a taxpayer is permitted to include as an expense excess profits tax paid or accrued. The Commissioner argued here that an excess profits tax refund must therefore be included as income. The District Court held that the Code does not so require. Taxpayer here had a 1946 operating loss which resulted in a 1944 excess profits tax refund received in 1947. At issue was the amount of 1946 loss available for 1947. The Commissioner argued that the 1944 excess profits tax refund accrued either in 1946 (when the loss was suffered) or in 1947 when the refund was received, and that in either year it should reduce the operating loss. The court said the argument that taxpayer can be allowed an operating loss only if it is a true economic loss was expressly rejected by the Supreme Court in *Lewyt* (349 U.S. 237). Second, there must have been an excess profits tax refund in *Lewyt* also, but the court made no adjustment for it. This court affirms. *Budd Co.*, CA-3, 11/27/57.

Records missing; operating loss not substantiated. Taxpayers claimed a refund for 1947 based on a net operating loss carryback from 1949. The loss allegedly arose in their auto sales partnership, but the records of the partnership are all missing. Since the loss cannot be substantiated, the refund is not allowed. *Gregory*, DC Ariz., 10/29/57.

Operating loss carryover affects medical, other deductions. In determining the amount of a 1948 net operating loss available as a carryover to 1950, deductions for the intervening years such as contributions and medical expenses are to be computed on the basis of the adjusted gross income including the carryover. *Weinstein*, 29 TC No. 19.

Can't accrue interest expense while payment is only contingent. Taxpayer, a real estate corporation, borrowed from banks on the security of its land and also issued subordinate obligations to builders improving these lands. While these builders' notes provided for interest from the date of execution, no interest would be payable until the indebtedness to the bank was entirely paid. The court holds that while bank indebtedness is outstanding, there is no liability for interest on the builders' notes and none can be accrued. *Guardian Investment Co.*, DC Tex., 5/9/57.

May continue consistent practice of allocating real property taxes over applicable period. An accrual basis taxpayer who, under the 1939 Code, had consistently allocated property taxes to the periods to which they relate, rather than deducting them in the year they accrued under applicable state law, may continue such practice in all years to which the 1954 Code applies. *Rev. Rul.* 57-539.

HOW IRS CHECKS INFORMATION RETURNS

IF YOU'VE wondered how many of the thousands and thousands of information returns are ever matched with the returns of the recipients, you'll be interested in the following conversation at the hearings of the House Subcommittee on Appropriations. Participating were Representative James of Pennsylvania; Clifford Stowe, Assistant Commissioner of Internal Revenue; and Commissioner Harrington.

Mr. James: Mr. Commissioner, earlier in the day we were discusing the multitude of operations in the Internal Revenue Service. Among other things, we spoke of the enormous amount of work which is involved in matching reports of employers and employees. Is that matching process carried further, for example, into matching dividends and interest reported by taxpayers and the reports of the dividends and interest paid to them by corporations or others?

Mr. Harrington: I will ask Mr. Stowe to answer that.

Mr. Stowe: The direct answer Mr. James, is "Yes," but it is only done on a partial basis.

Mr. Harrington: A test-check basis.

Mr. Stowe: In other words, we are not able to match and relate all of the information documents with all of the tax returns and then process them in terms of comparing the amount of income reported on the information document, such as the 1099, with the amount of that type of income reported.

We have a program going at the present time in which by a selective process we are making a special audit of some 350,000 returns with which we have matched those information documents, the 1099s and comparable forms, to determine just what percentage of leakage there is, and in what areas, income categories, professional areas, or things of that sort, which are involved, in order that we may know how to better select the returns which we should classify for examination. ☆

CORPORATE & PERSONAL PROBLEMS IN

Taxation of compensation

EDITED BY JOHN P. ALLISON, LL.B.

Market decline creates tax problems in changing stock options

STOCK OPTIONS which only a few short months ago promised substantial rewards now, at the lower market levels, have little or no value. Aside from the financial and personnel problems inherent in such a situation, managements contemplating revisions of their plans must pay attention to the tax rules applicable to amendments or new plans. The CPA firm of Lybrand, Ross Bros. & Montgomery prepared an analysis of the problem for their own staff and, with their permission, we bring you here the portion dealing with the tax aspects.

The continuing decline in security prices confronts many corporate executives with the stark realization that the timing of stock option plans adopted by their corporation within the past few years may have been either too late or too early. In many cases the executive holds today a contractual right of negligible value. The question automatically suggested is the feasibility of approaching the stockholders with an alternative which might equitably rectify the arrangement between the parties and, at the same time, not present any tax obstacles.

Although the initial reaction to a possible downward modification in purchase price may well be that it seems unreasonable to the stockholders, there may be a number of valid reasons for revising certain options. Should the executive be deprived of the incentive which the stockholders originally intended solely because of unfortunate timing where his option may have been granted at the crest of the market—with dim prospects that such peak will be exceeded throughout the remainder of the option period? Can the services of a new executive be retained after the option becomes of dubious value where his employment, in the first instance, may have been secured solely by providing a favorable future investment opportunity? What will be the reaction of executives with long service records who hold more or less worthless options if the company is obliged to bring in a new executive and grant him an option keyed to the present low level of market prices? How will the company guard itself against the possibility that its experienced executives will be lured away by its competitors who will be in a position to use lower-based options as bait?

Rather than ask the stockholders to approve the granting of an additional option keyed to the lower plateau of current market prices and thereby permit the employee to hold two options, it would seem more equitable, if a price modification should seem warranted, to grant the new option in consideration for the executive's agreement to cancel the old option.

The tax questions presented stem from Section 421(e) of the Code which provides that the modification of a stock option shall be considered as the granting of a new option and that as a general rule the fair market value to be used for deciding whether the option is a restricted stock option is the *higher* of the value at the date of granting the original option or the value on the date of modification. Reference to the higher fair market value on the original granting date would obviously disqualify the option as a restricted stock option and thereby prohibit the favored tax treatment to the executive. However, an exception to the above rule is provided by Section 421(e)(1) of the Code which may be susceptible of practical application, either presently or in the near future. The exception applies at such time as the aggregate of the monthly average fair market values of the stock for the 12 consecutive calendar months preceding that in which the modification occurs, divided by 12, is an amount less than 80% of the fair market value at the date of the *original granting* of the option. In that event, such original fair market value shall be disregarded in determining whether the option, as modified, qualifies as a restricted stock option. In the case of stocks listed on a stock exchange, the average fair market value for any month may be determined by adding the highest and lowest quoted selling prices and dividing the sum by two. There is no requirement in the law that all or any particular part of this 12-month test period must fall after the original option date.

The adjoining table lists the monthly range in prices during each of the past 12 months for three typical common stocks listed on the New York Stock Exchange, together with the 12-month average price and the minimum value on any prior granting date which would permit a favorable modification throughout November, 1957.

A prior option granted by A on any date when the market value exceeded $57.26, ($45.81 divided by 80%), could therefore be modified at any time throughout November with a revised purchase price related to market on date of new grant. Because of the sharp downward spiral of stock prices within the past six months it is very likely that A's moving 12-month average age may fall considerably below $45.81 in the immediately succeeding months and thus permit modification in later months of options which may have been granted at prices below $57.26. Possible applicability to more recent granting periods is evidenced by reference to Company C where beneficial modification would be possible with respect to an option which might have been granted as recently as July on a date the price exceeded $34.23 per share.

It is advisable, therefore, that 12-month running averages of a corporation's stock values be computed as set forth above, and compared with the fair market value of the stock at the date of the original granting of each outstanding option as well as with the current market value. With these data at hand, the opportunity for option modification without adverse tax consequences, i.e., when the average price of the stock for the preceding 12 calendar months is less than 80% of the fair market value on the original option granting date, will not be missed.

The required two-year period that must elapse between the granting of the option and the disposition of the option stock will begin anew as of the date of modification, under the Treasury's interpretation of the law. Where modification is subject to stockholder approval, the date of modification is determined as if such approval had not been required.

The opportunity for modification without penalty is also pertinent in the situation where the granting corporation now desires to compensate an executive to a greater degree than was done at the time the original option was granted. Assuming that the current lower plateau of stock value is temporary, if the above-described conditions are met, this objective may be accomplished through modification of the existing option rather than by the more common method of granting an additional option.

The fact that modification, extension, or renewal is deemed by the Code to be a new option should also make it possible, where the market value has declined, to change an existing 85% type restricted stock option to a 95% type, which makes it possible to avoid ordinary income on sale of option stock or on death of the employee while owning such stock. For example, if an option was originally granted to purchase stock at $85, the market value of which was $100 at the time, a later modification of the option price to $66.50 at a date when the market price is $70 would not only continue the option as a restricted stock option but also permit the more favorable tax treatment extended to the 95% type option, provided that the average price for the 12 calendar months preceding the month of the change was less than $80. There is a possibility, however, that the Treasury might interpret the Code as not permitting an option to be changed to a 95% type subsequent to its original granting. A favorable ruling should be obtained before relying on a modification as having that effect. ☆

MONTHLY PRICE RANGE FOR THREE TYPICAL STOCKS

	A		*B*		*C*	
	Lo	*Hi*	*Lo*	*Hi*	*Lo*	*Hi*
1956						
Nov.	55¼	62¼	38¾	44⅞	24¼	27½
Dec.	54⅝	59⅜	38¾	43¼	23½	25¾
1957						
Jan.	47⅜	59⅝	33¾	39¼	23⅞	28⅞
Feb.	44¾	49⅜	29⅝	33⅛	24½	27⅞
Mar.	47¾	51⅜	27½	31⅜	24¼	25½
April	46⅜	52¼	28¾	31¾	24⅛	25¾
May	45¼	48¾	30	34⅞	24¾	31¼
June	42⅛	48¼	28⅝	31½	29½	33¾
July	39¾	43⅞	24	29½	31⅝	34¾
Aug.	35	39⅞	21¾	25½	28¾	33
Sept.	30¾	37	21⅞	26⅜	26¼	30
Oct.	24⅛	34	20⅛	27¾	20¼	27½
Total 12 mos.	513⅜	586	343½	399⅛	305⅜	351½
Average price for prior 12 months	$45.81					
Minimum value on prior grant date permitting Nov. modification	$57.26		$30.49	$38.68	$27.38	$34.23

Berle forsees public control of administration of pension funds

THE GROWTH of pension funds, their importance to each worker and their inevitable effect on the economy mean that public control is coming and indeed in some aspects is needed now. Such control was advocated by Adolf A. Berle, Jr., New York attorney and Professor of Law at Columbia University, in a recent talk before the Insurance Section of the American Bar Association in New York.

"The beneficiaries of these funds are entitled to protection," Professor Berle said. "Under the prevailing system their contributions are really compelled by circumstances. The individual worker has very little to say about the terms of the pension agreement. This is settled for him by others when the trust or insurance arrangement, as the case may be, is negotiated. The result is really a variety of forced savings. This means that there is a strong public interest in seeing to it that he gets the benefits he has earned when the time comes, or the specified event occurs.

"The law at the moment is not, it seems to me, in satisfactory shape. In one sense, pension and other funds have grown very quickly, and they are in somewhat the shape that the insurance funds were before the crystallization of regulation which took place after the *Hughes* investigation half a century ago.

"First, it seems to me there should be a uniform system of disclosure, audit and actuarial review. It is absurd to say that these arrangements are merely private contracts, or that the many millions of workers covered by them voluntarily contracted in accordance with the terms of the present agreements. They did not: they took what was given them. The first step, which can be taken now, is a uniform system of audit and review. This ought to include not merely the conventional accountants' audit, but also the actuarial review which will disclose whether or not the funds, either in the hands of an insurance company or in the hands of a trustee, will be in condition to meet the expectations of the beneficiaries when they arise.

"Second, it seems to me that appropriate arrangements ought to be made so that the beneficiaries have access to the courts when necessary to protect the adminstration of the funds. As far as the law appears to go now, a beneficiary has no right to go into court to correct any abuse or maladministration of funds. He does not have the kind of right that is granted a stockholder of a corporation. He must wait until some agreement he has is violated and by that time it is usually too late.

"Third, I believe that the terms of trust provisions should be standardized.

This was an issue fought out many years ago in respect to insurance policies, and it seems to me that the same considerations apply now.

Agreement on standards

"Because legislation is a long, hard road, it might well be that the banks and insurance companies alike which hold these funds could draw up standard clauses themselves, and by agreement work out a reasonable standardization.

"In this connection, let me say that I think some greater flexibility ought to be given to the investment powers of insurance companies. For practical purposes a considerable volume of the funds held by insurance companies are held on the same terms as those held by banks as trustees. These are the so-called "deposit administration" arrangements. The insurance company holds the fund, invests it, builds it up, and on the occurrence of a specified event buys from the fund an insurance policy for the beneficiary. Meanwhile, the funds are held for investment. The practice is to assume that these funds when held by insurance companies are subject to the same restrictions in investment as apply to other funds held by insurance companies. The banks, on the other hand, are not subject to such restrictions. Since the payments from these funds will be made later at a time when price levels may rise, the fund must have in mind some hedge against inflation.

"It ought to be added that the more conservatively managed bank funds do not take advantage of their flexibility. One of the most famous averages a return somewhat less than the average return received by the big insurance companies. But this is partly due to the fact that pension trusts have not had access to the home mortgage market which yields a higher interest return. Within the past few weeks we think we have found a way by which pension trusts especially do get access to the mortgage market.

"The point is that if the trustee funds ought to be subject to some review, the insurance company funds ought to be entitled to rather greater flexibility.

"My fourth point is one taken at very long view. We shall have the problem of a very great centralization of investment power—if we do not have it now. Already the total funds involved in these trusts amount to $30 billion or so; they are certain to treble in volume before they level out, as they will. This is a substantial portion of the savings of the country. Their investment will be in a very few hands. There have always been reactions to this sort of centralization in American history. I have no pat solution. A great deal of study will be needed. One of the insurance companies, the Prudential, has been doing a great deal of work on decentralization. This may offer possibilities. In time, of course, there may be some guiding of capital credit, as the Federal Reserve System now guides short-term commercial credit. But this is a problem a long way off, merely looming over the horizon now. ☆

New compensation decisions this month

Contingent compensation valued for estate tax at or after death, [*Certiorari denied*). Decedent's contract with his employer provided that upon his separation from employment or death, specified sums were to be paid him or his estate annually for a period of fifteen years. The employer's obligation, however, was contingent upon the decedent's continuing to fulfill certain conditions of his employment during his lifetime. The administratrix of his estate contends that, because the payments were thus contingent, they possessed no market value immediately prior to death and were consequently not subject to estate tax. The Third Circuit held however that the estate tax attaches at the moment of death, and the decedent's assets are to be valued as of that time or immediately thereafter. Since the contract rights were then vested, their commuted value is includible in decedent's gross estate. *Blum Estate (Goodman, Ex'r), cert. den.*, 10/14/57.

Death benefit exclusion not to be prorated. The $5,000 death benefit exclusion must be applied to the first $5,000 paid and cannot be prorated over the period during which monthly installments of a death benefit in excess of $5,000 will be paid. The IRS points out that the Code makes no provision for prorating. *Rev. Rul.* 57-483.

Corporate payment to officer's widow a gift. Taxpayer's husband was the former president and chairman of the board of directors of a family owned corporation. When he died in February, the corporation paid taxpayer an amount equal to his salary for the remainder of the year. It treated it on its books and returns as salary. The court decides on evidence of the intent of the directors to make a gift, that the payments were a gift, not income. *Nixon*, DC Tenn., 8/18/57.

Payment to executive's widow a gift, not income. Taxpayer's husband was an officer, stockholder and director of a corporation. He owned less than 1% of the stock of the company. Upon his death, the corporation paid her some $34,000, an amount equal to nine months' salary of her late husband, in accord with the policy, adopted some five years previously, of paying nine months salary to the widows of its higher officers. However, the corporation was under no legal obligation to pay a death benefit. The court finds that the corporation intended to make a gift and therefor the payment is not income to taxpayer. *Simpson*, DC Ill., 11/27/57.

Assignment of restricted option stock to agent not a disposition; nor is loan to short seller. The Code provides special rules for the tax treatment of stock obtained under a restricted stock option upon the "disposition" of the stock. It defines disposition as including a transfer of legal title. Turning to the stock transfer tax cases turning on transfer of title, the IRS concludes that an assignment, or endorsement in blank, to an agent, such as a bank or broker, who wishes to have title for convenience but who remains at all times subject to the control of the principal is not such a transfer as amount to a disposition. If the agent is given the power to lend the shares, usually to short sellers, such a loan, and the receipt back of other certificates, is not a disposition under the specific provision exempting the tax-free exchange of common for common, or preferred for preferred, in the same company. *Rev. Rul.* 57-451.

Can't increase self-employment income by having wife pay business expenses. In a sole proprietorship income from the business must be reduced by allowable business expenses for purposes of computing taxable net income and self-employment income. Accordingly, a wife cannot prevent a reduction in her husband's self-employment income by agreeing to pay the expenses of operating his business. *Rev. Rul.* 57-538.

TAX PLANNING AND
Business management
EDITED BY CHARLES S. LOWRIMORE, Sr., CPA

Tax advantages and hazards in operating as a personal holding company

by **BERT L. KLOOSTER**

Classification as a personal holding company is not always the disaster it is usually considered to be. In some situations, it can provide unique advantages. Mr. Klooster points out some of the benefits to be obtained by operating as a personal holding company when a business is properly planned for such a status. On the other hand, he warns the unwary of the dangers if a business finds itself in this category by accident, in this paper presented at the 1957 Marquette University Tax Institute.

FOR A NUMBER of years dodging taxes by use of the incorporated pocketbook has been unpopular because of the personal holding company tax. Prior to the advent of that tax in 1934, individual taxpayers in the higher income tax brackets could put their investments into a corporation and have their income on such investments taxed at corporation rates, lower than the high individual income tax brackets. Tax savings resulted from merely retaining the investment income in the corporation and not distributing it as dividends. Congress then effectively prevented the escape of individual taxes by levying the personal holding company tax in addition to the ordinary corporate income taxes.

An additional tax

At the present time, the personal holding company tax is in addition to the ordinary income taxes of 30% of the first $25,000 and 52% of the excess above $25,000.[1] The personal holding company tax is at the rate of 75% on the first $2,000 of undistributed income and at the rate of 85% on all undistributed corporate income in excess of the first $2,000.[2]

A corporation is automatically a personal holding company[3] if it meets both of these two tests:

1. More than 50% in value of the corporation's stock is owned, during the last half of the taxable year, directly or indirectly, by or for not more than five individuals. Since an individual is considered to own the stock owned by or for his family we may say that the first requirement of a personal holding company is that more than 50% in value of the corporation's stock is owned directly, or indirectly, by or for members of five or less families.

2. The second automatic requirement for a personal holding company relates to operations. At least 80% of the gross income must consist of interest, dividends and other investment income, or income from certain personal service contracts.

The personal holding company tax is not levied upon certain corporations: corporations which are exempt from income tax, banks, life insurance companies, surety companies and certain finance and lending companies.

Generally, the formation of a personal holding company is not deliberately undertaken unless the shareholders are in such low income tax brackets that they can avoid the personal holding company penalty tax by distributing all of the company income to themselves without paying high individual income taxes.

For example, if a corporation whose stockholders are in lower individual income tax brackets sells the assets of the corporate business, the stockholders may wish to have the corporation invest the proceeds of sale in securities, rather than reduce such proceeds by the capital gain tax they would pay as individuals if the corporation were liquidated. By leaving the proceeds in the corporation, they would have more money to invest and the stockholders could avoid the personal holding company penalty tax by distributions of all of the corporate income after paying ordinary corporate income taxes thereon. The benefit derived from the larger investment must be weighed against the ordinary corporate income taxes which reduce the investment income before it can be distributed. If the funds left in the corporation are invested in stocks of domestic corporations, the credit of 85%[4] would subject only 15% of dividends received by the corporation to the ordinary corporate income tax. On the other hand interest, royalties, or rentals would be fully subject to ordinary corporation income taxes before they could be distributed. The extent of the advantage derived by thus turning a business corporation into a personal holding company, even where the stockholders can afford to take distribution of all the corporation's income, will require computations of the results of investments by the corporation before liquidation and investments by the individual stockholders after liquidation. Factors which will affect the comparative results will include the total amount of money involved and the types of investments contemplated.

The problem presented for stockholders in the top individual income tax brackets can be completely solved only if their investment corporation, while not distributing the investment income, nevertheless is not subject to the personal holding company tax. Those two objectives can be accomplished by avoiding either one of the two requirements for classification as a personal holding company, that is, by avoiding the stock ownership requirement, or the requirement that at least 80% of the income be personal holding company income.

A favorite device—real estate

A favorite device for completely solving the problem is to cause the corporation owning securities to purchase real estate subject to a long-term lease and to

[1] Int. Rev. Code Sec. 11.
[2] Int. Rev. Code Sec. 541.
[3] Int. Rev. Code Sec. 542.
[4] Int. Rev. Code Sec. 243.
[5] Sec. 543(a)(7).

[*Mr. Klooster is an attorney with the Chicago law firm of Chapman & Cutler.*]

finance the purchase by issuing bonds or incurring other indebtedness, in order to obtain rentals which will exceed 50% of the gross income of the corporation. Rentals cease to be personal holding company income when they exceed 50% of gross income[5] (even though the interest paid on the indebtedness incurred to purchase the real estate may be as large, at first, as the rental). The income from the securities, therefore, does not need to be distributed in order to avoid the personal holding company penalty tax. The indebtedness incurred to acquire the real estate is usually amply secured by a pledge of the securities held by the corporation in addition to mortgaging the real estate.

As part of this favorite device, the lessee of the real estate is sometimes given the option to purchase the property, after a certain number of years, at a very low price. Such an arrangement is sure to be scrutinized by the Treasury Department to determine whether the low option price is fair and is justified by expected depreciation or by other circumstances, and at the same time to determine whether the relatively high rental paid by the lessee is a fair and reasonable rental for the property involved or whether part of the rental in fact represents installments on the purchase price. If part of the rental is thus determined to be received as purchase price and not as bona fide rental, the entire plan may fail. If the total rentals received by the investment company are determined to be less than 50% of its gross income, it may be subject to the personal holding company penalty tax at rates of 75% and 85%.

Tax on accumulation of income

The accumulation of income by the corporation in carrying out that "favorite device" would not be subject to the accumulated earnings tax imposed by Section 531 if the accumulation is for the reasonable needs of the business in paying off a bona fide corporate indebtedness incurred in a bona fide purchase of real estate. The accumulated earnings tax (at the rate of 27.5% of the first $100,000 of undistributed earnings, and 38.5% on the excess above $100,000) is levied upon corporate income accumulated for the purpose of avoiding the income tax with respect to shareholders unless the corporation proves that the accumulation is for the reasonable needs of the business and not to avoid income tax on individual shareholders. The personal holding company tax differs from the accumulated earnings tax in that the personal holding company tax applies automatically if the requirements with respect to stock ownership and personal holding company gross income are met. The accumulated earnings tax depends upon the existence of the purpose to avoid income taxes on shareholders by accumulating income. We merely mention the accumulated earnings tax as bearing on this question; it is beyond the scope of this paper.

Other methods of escaping the personal holding company penalty tax are quite comparable to the use of real estate. Instead of the purchase of real estate subject to a lease, the corporation might purchase a manufacturing or mercantile business and thus keep its personal holding company income below the qualifying figure of 80%.

Stock ownership requirement

An investment company cannot be a personal holding company unless more than 50% in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals and their families. An individual is considered to own the stock owned by or for his family, defined as including "only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants."[6]

If stock ownership can be spread sufficiently, the corporation will be able to receive any kind of gross income with no danger of being liable for a personal holding company tax. But all the elements of constructive ownership of the company's stock must be taken into account. In addition to constructive ownership by members of an individual's family, a person is considered as owning the stock he has an option to acquire;[7] the owner of bonds convertible into stock is considered as owning the stock into which he may convert his bonds,[8] and stock owned, directly or indirectly, by or for a corporation, partnership, estate or trust, is considered as owned proportionately by its shareholders, partners, or beneficiaries.[9]

Preferred stock

The stock ownership test of a personal holding company is whether five or less own more than 50% *in value* of its outstanding stock. There may be cases in which preferred stock that is widely held represents most of the value; profits of such a company in excess of dividend requirements of the preferred stock could accumulate for the benefit of the common stockholders. There are doubtless other investment situations where preferred stock financing would be desirable. Debt financing might ordinarily be selected, however, so that accumulated earnings might be used to pay off a bona fide debt and thus supply the reasonable business need for avoidance of the accumulated earnings tax.

Change in stock ownership

If an investment corporation has *only one class of stock outstanding* (and any corporate stockholder also has only one class of stock outstanding), the value of the stock is of no consequence in determining whether over half the stock is owned by five or less families. Vigilance is required, however, to catch changes in stock ownership which may suddenly cause the corporation to meet the stock ownership requirement for the penalty tax. Such changes in ownership include those occurring by marriage, death, transfer in trust, purchase and sale, option agreements and transfers to or from partners or partnerships; attention must be paid to changes involving the ultimate individual ownership of outstanding stock of either the investment corporation or one of its corporate stockholders.

If an investment corporation or its corporate stockholder has *more than one class of stock outstanding*, vigilance is required not only to keep informed of all family and other changes just mentioned, but also to watch the value of the stock held by each individual stockholder, actually and constructively. The accumulation of earnings in one year alone might be sufficient to change relative values of preferred and common stocks and meet the stock ownership requirement for the penalty tax.

Gross income requirement

Even though it may be impossible for a close corporation to avoid the stock

[6] Sec. 544(a)(2).
[7] Sec. 544(a)(3).
[8] Sec. 544(b) and Proposed Reg. §1.544-5.
[9] Sec. 544(a)(1).
[10] Sec. 542(a)(1).
[11] Sec. 61(a).
[12] Par. 542-2 of the Prop. Reg. refers to Sec. 61 and the Regulations thereunder for what constitutes gross income and then states: "However, for the purpose of meeting the percentage requirement of Sec. 542, gross income is not synonomous with gross receipts and, accordingly, the amount of gross income for this purpose may differ from the amount determined under Sec. 61 for ordinary corporate tax purposes."
[13] Sicanoff Vegetable Oil Corporation, 27 TC No.

ownership requirement, avoidance of the gross income requirement will permit that corporation to escape the penalty tax; there can be no liability for that tax unless at least 80% of its gross income for a taxable year is personal holding company income as defined by the statute.[10]

Computation of gross income

To escape the personal holding company penalty tax, it is important to determine when the corporation will have personal holding company income equal to 80% of gross income. Gross receipts are gross income in the case of interest, dividends, and compensation for services,[11] but gross receipts are not the gross income of a manufacturing business.[12] Some of the rules for determining gross income are as follows:

1. "In a manufacturing, merchandising, or mining business, 'gross income' means the total sales, less the cost of goods sold . . ." Prop. Reg. §1.61-3.

2. In the case of mineral, oil or gas production payments, gross income is the excess of payments received over a proportionate amount of the cost of payment rights. Prop. Reg. §1.542-2.

3. Gross income from dealings in property is "the excess of the amount realized over the unrecovered cost of other basis for the property sold or exchanged." Prop. Reg. §1.61-6.

4. Gross income from stock and security transactions of non-dealers includes "only the excess of gains over losses from such transactions" (Section 543(b)(1)); gross income from other sources may not be reduced by any excess of losses over gains. Prop. Reg. §1.543-2.

5. For commodity transactions similarly only the excess of gains over losses is included (Section 543(b)(2)); any excess of loss over gains may not be applied against gains from stock and security transactions, or against any other gross income. Prop. Reg. §1-543-2.

6. Gross income does not include that part of an annuity representing a proportionate part of the investment in the annuity contract (Section 72(b)).

7. If a consolidated return can be filed for a group of corporations, the gross income requirement is determined for the group instead of for separate corporations (Section 542(b)).

8. Gross income of a corporate partner or joint venturer includes its distributive share of the gross income of the partnership or joint venture. (Sec. 702(c); Sec. 61(a)(13). Compare article by Frank H. Levine "Gross Income In A Personal Holding Company," 9 *Tax Law Review*, 453, 472, Charles H. Palda, 27 TC 445, 447, and Doris V. Clark, 29 TC No. 24.)

9. Foreign corporations, whether resident or non-resident, are liable for personal holding company tax with respect to their income from U. S. sources if at least 80% of their gross income from U. S. sources is personal holding company income (without regard to their income from foreign sources). Prop. Reg. §1.545-1(b). *Porto Rico Coal Co.*, 44 BTA 221, 126 F.2d 212, (aff'd 2nd Cir.), 42-1 USTC Par. 9315. (a) Foreign personal holding companies defined in Section 552 are not liable for the penalty tax (Section 542(c)(5)). (b) Also, the penalty tax does not apply to foreign corporations having only non-resident alien stockholders and less than half of their gross income from U. S. sources (Section 542(c)(10)).

Commodity transactions

Gains from futures transactions in any commodity on or subject to the rules of the Board of Trade, or Commodity Exchange are included in personal holding company gross income, with the exception of such gains realized by a producer, processor, merchant, or handler of the commodity which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business. The Tax Court recently held that certain alleged hedging transactions did not constitute hedging because such transactions did not involve a position taken in the futures market to offset a risk with respect to actuals, and were not bona fide hedges within the meaning of the statute. Consequently all gains from futures transactions were included in personal holding company gross income.[13] The case is on appeal to the Seventh Circuit.

Personal service contract income

The easiest way to keep personal service contract income out of the personal service company gross income classification is merely *not* to give some person other than the corporation the right to designate the individual who is to perform the service. If another must have the right to designate the person to perform, the income will be kept out of the personal holding company classification if the person who is designated to perform the service has less than 25% in value of the corporation's stock.[14] In one case, a general management corporation contracted to provide the management for a publishing company. The contract designated the person who was to act as comptroller. Through other employees the management company also audited the publishing company's accounts, prepared its income tax returns, and made up statements of costs, balance sheets, and similar reports. The court held that these other services were a mere supplying of assistance to the man who acted as comptroller, and that the income received under the contract was personal holding company income[15] of the management corporation.

In another case, a corporation engaged in the business of selling fire insurance was the assignee of certain insurance agency agreements which designated a particular person who owned more than 25% of the stock of the corporation as agent for a fire insurance company. The commissions received under such contracts were held to be personal holding company gross income.[16]

Interest as rental

The Code defines rent as including interest on debts owed to the corporation on the sale by it of real property "held primarily for sale to customers in the ordinary course of its trade or business" (Section 543(a)(7)). Because rentals cease to be personal holding company income when they exceed 50% of gross income, taxpayers strive to have the interest on debts classified as rents rather than as interest. The rental classification was denied in one case because the court held the acquisition and disposal of two pieces of property did not constitute an ordinary course of business.[17] An attempt to classify interest as rent also failed in another case where the indebtedness arose from the sale of property which, the court held, had been held by a corporation for investment purposes rather than for sale to customers in the ordinary course of its trade or business.[18]

Rent received for the use of corporation property from a person owning 25% or more in value of the outstand-

129, *on appeal to* Court of Appeals, Seventh Circuit.
[14] Sec. 543(a)(5).
[15] General Management Corp., 135 F.2d 882 ,(7th Cir.), 43-1 USTC §9447. *Cert. den.* (*Affg* 46 BTA 738).
[16] Rev. Rul. 54-34, 1954-1 CB 175.
[17] Kent Industrial Corp., in dissolution et al., 25 TC 315.
[18] The West End Co., 23 TC 815.
[19] Sec. 543(a)(6).
[20] Minnesota Mortuaries, Inc., 4 TC 280, *acq.* 1945 CB 5.
[21] 320 E. 47th St. Corp., 243 F.2d 894 (2nd Cir.). *rev'g and remanding* 26 TC No. 66. *Cert. den.*
[22] Prop. Reg. §1.543-1(b)(3).

ing stock of a corporation is personal holding company income regardless of whether such rental income exceeds 50% of the gross income of the corporation. But under the Revenue Act of 1954, this rule is not applicable if the corporation's other personal holding company income (except rentals) is less than 10% of the total gross income.[19]

A warning should be given that stockholders no longer can insulate rental paid for property used by them from the personal holding company classification by forming a second corporation through which they rent from the first. The Tax Court has held that where a corporation owning real estate also owned 85% of the stock of a second corporation which was its tenant, the personal holding company classification did not apply to the rentals paid to the first corporation.[20] The Second Circuit, however, has now held that rental income received from a lessee corporation whose shareholders are identical with those of the lessor corporation constitutes indirect rental by the stockholders of the first corporation.[21]

Royalties or rents

The question of royalties as personal holding company income has been the subject of much litigation. The law has a separate rule for mineral, oil, or gas royalties. Other royalties are defined by the proposed Regulations as including "amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trade marks, trade brands, franchises, and other like property. It does not, however, include rents."[22]

A corporate taxpayer succeeded in having compensation received by it from the distribution and exhibition of its motion pictures considered as rent instead of royalties. As a result, 50% of its gross income was from rental, was not personal holding company income, and the corporation was not subject to the personal holding company penalty tax.[23]

Another success for a corporation, substantially all of whose income was royalties, was that of the Heater Corporation, which as licensor granted its licensee exclusive right to make, use and sell (and to sublicense others to make, use and sell) any products embodying any of the inventions under certain patents. The licensee agreed to pay the Heater Corporation a royalty based on the net sales price of the heating units it sold. Heater Corporation also granted the licensee the option to purchase the patents for $250,000 at any time before a fixed date. Heater Corporation contended, and the court held, that its agreement effected a sale of patents and that the amounts received were purchase price, not royalties.[24]

But a similar contention failed in another case. Dairy Queen of Oklahoma, Inc., was organized for the purpose of holding the exclusive right and license to use, manufacture and sell machines for dispensing an ice cream mix registered under the trade name of Dairy Queen. It was obliged to pay its licensors a fee for each gallon of mix used. Dairy Queen entered into subfranchise agreements covering exclusive territories. The franchised dealers agreed to pay Dairy Queen a fee on each gallon of mix used in the machines. Dairy Queen argued that the amounts it received from franchised dealers were proceeds of sale of capital assets. The Tax Court held, however, that the franchise agreements were mere licensing agreements and that the amounts received were royalties.[25] The Tenth Circuit has just reversed.

Royalties or service payments

Coca-Cola Bottling Company of Sacramento, Ltd. claimed that under the terms of a sublicense agreement with its parent bottler it was purchasing from it Coca-Cola syrup at a price of $1.30 a gallon; and that it was selling that syrup to a partnership for $1.50 a gallon under the terms of a subbottling agreement so that 20¢ a gallon gained by it represented profits on the resale of Coca-Cola syrup. The court pointed out, however, that the Sacramento corporation performed no actual services in connection with the procurement of the syrup and merely received the payments from the partnership and passed them on to its supplier after deducting 20¢ a gallon. It held that the 20¢ a gallon was a royalty for the exclusive license granted to the partnership.[26]

Licensing agreements

Precious Metals Developing Co., Inc., owned patents covering processes for making silver articles tarnish-resistant. One of these patents came into the hands of Baker & Co., Inc., which entered into license agreements with many jewelers. Baker paid over to Precious Metals 4% of Baker's sales of solutions. Precious Metals contended that the payments received were not royalties but rather commissions on the sales made by Baker. The Tax Court held that a commission may be a royalty and was, in this case.[27]

Another corporate taxpayer succeeded in preventing a portion of license payments it received from being considered as royalties, by showing that such portion represented fees for engineering and other services rendered.[28]

Another taxpayer made an unsuccessful claim that moneys received under a license agreement were a share in profits from a joint venture and not royalties. The court interpreted the license agreement to mean that all that the corporate licensor retained was the right to supervise methods of brewing, advertising and marketing of beer sold under the name "Lemp" for protection and preservation of what the licensor considered to be a valuable property right. The agreement made no mention of sharing either profits or losses and the fact that the licensor and licensee cooperated did not indicate to the Tax Court that they intended to engage in the manufacture and sale of beer as a joint enterprise. The court, therefore, held that the payments made pursuant to the agreements were royalties.[29]

After they lost once, the proprietors of "Bank Night" changed the nature of their income from royalties to service payments. Payments to the licensor under contracts with theatre operators were first held to be royalties.[30] Subsequently, the licensor advertised and furnished a "Bank Night Theatre Service" designed to give the independent theatre owner specialized advice on the operation of the program in the most efficient and economical manner. The Court of Appeals, Tenth Circuit, with one dissent held that the income derived was not royalties.[31]

Mineral, oil or gas royalties

Mineral, oil, or gas royalties are separately provided for. They are personal holding company income unless two factors are present, namely: they must be 50% or more of the gross income, and business expense deductions, other than compensation for personal services rendered by shareholders, must be 15% or

[23] Rev. Rul. 54-284, 1954-2 CB 275.
[24] The Heater Corp., 13 TCM 867.
[25] Dairy Queen of Oklahoma, Inc., dissolved et al., 26 TC 61, rv'd by Tenth Circuit.
[26] Coca-Cola Bottling Co., 17 TC 101, *acq., and aff'd on other ground*, N. M. Sellers and Gladys Sellers, 218 F.2dd 380 (9th Cir.), 55-1 USTC ¶9158.
[27] Precious Metals Developing Co., Inc., TCM 1956-230.
[28] U. S. Universal Joints Co., 46 BTA 111, *acq.* 1942-1 CB 17.
[29] William J. Lemp Bottling Company, 18 TC

more of the gross income.[32] The term "minerals" includes ores of metals, coal, oil, gas, and all other natural mineral and nonmetallic deposits except minerals derived from sea water, the air, or from similar inexhaustible sources. It includes but is not limited to all of the minerals and other natural deposits subject to percentage depletion.[33]

In a case involving royalties on coal the Third Circuit said that the distinction between "rent" and "royalties" is "the commonly accepted one that rent is a compensation for the right to use property which is fixed and certain in amount and payable periodically over a fixed period regardless of the extent of the use of the property, while royalty is a compensation for the use of property which is based as to amount entirely upon the use actually made of the property."[34]

An item designated receipts under oil and gas leases consisting of $1 per acre per year paid by the lessee to the lessor was held to be rent and not royalty.[35]

Assigned interest

The Clarion Oil Co., which was the assignee of a three-fourths interest in lessee rights under an oil, gas and mineral lease, assigned its interest in the lease to Humble Oil & Refining Company for a cash consideration of $120,000, an oil payment of $240,000 out of a share of oil if, as and when produced, and an overriding royalty of 1/32 of oil which might be produced. The Humble Oil Company drilled a dry hole and the lease was abandoned. Since no oil was produced, the Clarion Oil Company received nothing from the assignment of the lease except the $120,000 cash payment. The Court of Appeals, District of Columbia, reversing the Tax Court, held that the cash payment of $120,000 was a bonus, an advance royalty for depletion purposes, and therefore a royalty for personal holding company purposes.[36]

Taxable income

What income is subject to the personal holding company tax at rates of 75% and 85%? The tax is levied on *undistributed income,* that is, the income which is left after deducting dividends paid. The determination of taxable income starts with the income which is subject to the ordinary corporate income taxes. Such income is then adjusted as set out in Section 545, some of the adjustments being summarized briefly as follows:

1. Income taxes accrued are allowed as a deduction (but income taxes paid are allowed if consistently deducted prior to 1954).

2. Charitable contributions are deductible up to 20% plus 10% for contributions to churches, colleges and hospitals (the same as allowed an individual) instead of 5% of adjusted gross income allowed corporations.

3. Certain special deductions for corporations are disallowed, including: (a) Deduction for partially tax-exempt interest (Section 545(b)(3) and Section 242); (b) The 85% deduction for dividends received from domestic corporations (Section 545(b)(3) and Section 243.)); (c) Deductions are disallowed on certain dividends received on preferred stock of a public utility, from foreign corporations ,and from China Trade Act corporations (Section 545(b)(3) and Sections 244, 245, 246 and 247).

4. Net operating loss may only be carried forward from the preceding taxable year.

5. Excess of long-term capital gain over net short-term capital losses are excluded after reducing such gain by the capital gain tax paid thereon (Section 545(b)(5); *Rev. Rul.* 55-702, 1955-2, C.B. 272.)

6. A special deduction is allowed to bank affiliates for earnings and profits devoted to the acquisition of readily marketable assets (Section 601).

7. A deduction is allowed for reasonable amounts paid or set aside to retire indebtedness incurred before Jan. 1, '34.

8. Expenses and depreciation in excess of rent received on property are disallowed as a deduction unless (a) the rent was the highest obtainable, (b) the property was held in the course of business for profit, and (c) there was either a reasonable expectation of profit thereon or the property was necessary to the conduct of the business.

9. A Federal tax lien to which the corporation is subject is deducted *each* year to the extent of personal holding company income otherwise computed for that year, but all such deductions must be added back to personal holding company income in the year in which the lien is paid or satisfied (Proposed Regulations §1.545-2(i)). ☆

THE STATUS OF TAX WORK AND THE CPA

THERE WAS a time a few years ago when many [tax men] were concerned that the scope of service in the tax field might be limited by some arbitrary or judicial actions. I may be wrong—but I feel that the danger is largely past. I think we may still have some isolated troubles arising from suits for fees for tax work by CPAs, or from local conflicts in which personalities may be involved. But I think that the national leadership of the Bar has learned more about the place of CPAs in the tax field and has come to accept the fact that this is an area in which both lawyers and CPAs must work. They must work together. I have a feeling that there will be more cooperation between lawyers and CPAs in actual tax practice at the local level than there has been in the past. There will be more referrals to CPAs and more referrals to lawyers by CPAs as time goes on, but no diminuation in volume. Perhaps there will even be a greater volume.

I think one interesting sign is the fact that when the Kentucky Bar Association's Unauthorized Practice Committee a few months ago issued an opinion that the preparation of income tax returns was the practice of law, and that it should be done only by lawyers, the American Bar Association representatives on our National Conference Group said the opinion was a violation of the agreement they had made with the Institute. They sent delegations down into Kentucky to talk to the local bar. Partly as a result of that and partly because of local representations, the opinion is not being pressed, and has no legal effect. Things are going on as they did before. I think this is very encouraging. . . . *John L. Carey,* Executive Director, American Institute of CPAs, in an address before the Middle Atlantic States Accounting Conference at Myrtle Beach, S. C.

586, *acq.*
[30] Affiliated Enterprises, Inc., 123 F.2d 665, (10th Cir.), 41-2 USTC §9735, cert. den.
[31] Affiliated Enterprises, Inc., 140 F.2d 647, (10th Cir), 44-1 USTC §9178.
[32] Sec. 543(a)(8).
[33] Prop. Reg. §1.543-1(b)(11) and Prop. Reg. §1.611-1(d)(5).
[34] Logan Coal & Timber Association, 122 F.2d 847, (3rd Cir.), 41-2 USTC §9682.
[35] IT 3401 1940-2 CB 166.
[36] Clarion Oil Company, 148 F.2d 671, (D.C., Cir.), 45-1 USTC §9218, *cert. den.*

TAX STRATEGY NEWS OF THE REVENUE SERVICE

Effective tax procedures

EDITED BY MARTIN M. LORE, LL.B. CPA

Tax Court is fulfilling its function; no fundamental changes needed

by J. EDGAR MURDOCK

Over 31 years of Chief Judge Murdock's life have been devoted to the Tax Court. During those years he has studied the problem of how the court can best serve the interests of the Government and of the taxpayer. Numerous suggestions for improvement have been made; some adopted, some rejected. In the following article, drawn from an address to the Tax Executives Institute Twelfth Annual Conference, Judge Murdock reviews current proposals for change and concludes that no fundamental revisions are necessary, provided the IRS continues to reach agreement with the taxpayer in the majority of all tax disputes.

Most of the suggestions which I have heard for changes in the Tax Court are for methods of increasing the number of cases closed, in one way or another, through the Tax Court. It should be understood in this connection that the Tax Court, itself, was not designed for quantity production and, in my opinion, should not be made into a quantity-production court. The Commissioner has been able over a long period, including three wars with their accompanying high taxes, to keep the number of cases which must be decided by the Tax Court within reasonable limits; he is keenly interested in doing just that, and there is no reason now to suppose that this happy situation may not continue. Should it fail, then some real reconstruction would be required, and it might be necessary to scatter a large number of tax judges all over the country like district court judges and abandon the present idea of an integrated Tax Court having jurisdiction over the entire nation. That, in my opinion, would be unfortunate. If tax rates could be reduced and many present inequities eliminated, the number of litigated cases would decline, as they did in the 1920's; but that important subject is beyond the scope of this present discussion.

I will briefly discuss some of the suggestions which I have heard. One is that the Tax Court could "make a more liberal use of commissioners." The Tax Court has given this idea a thorough trial, but the results have been far from satisfactory. I have never been enthusiastic about an extended use of commissioners, although their use is justified and several times has proved satisfactory in certain situations. I would again use a commissioner whenever a similar occasion arises. I do not approve of the use of commissioners if it can be avoided, since each litigant is entitled to have his case heard and decided solely by a judge of the Tax Court. A number of the judges have similar views.

A case heard by a commissioner must be assigned to a judge after the commissioner has made proposed findings of fact. The judge must satisfy himself about the findings of fact and familiarize himself with the record. That takes longer than it would had the judge heard the case in the first place; and if he had heard the case in the first place, he would be better able to decide the case more promptly in accordance with his own judgment. The use of commissioners cannot help but have considerable influence upon the ultimate decision, and their use has not speeded up production.

Ten different attorneys of the Tax Court have been designated from time to time as commissioners to hear a total of 407 cases. Six of them, however, heard only a single case or a group of cases. The other four attorneys who acted as commissioners heard calendars of unrelated cases. The greatest advantage derived from the use of those ten commissioners was that 240 of the cases assigned to them were settled by stipulations or dismissals. 163 were heard on the merits. Three full-time commissioners were used extensively in a number of Section 722 cases in which it was anticipated that the trial time would be relatively long. All three of those men had had many years of experience with the Tax Court before being chosen for this work. The commissioner with the best production record of those three retired as an employee of the court at the end of 1956. He heard 59 cases on their merits, made findings of fact and further assisted in the disposition of those cases at the rate of 13¼ a year. It is unlikely that the court could obtain another man for the job who would equal this man's record of 13¼ cases a year, and even that is relatively slow going. The other two commissioners heard a total of 51 cases on the merits. One of them was disposing of his cases at the rate of one a year, and the other at the rate of 3⅔ cases a year. They still have cases heard in 1954. This situation was very disturbing to me when I came in as chief judge on July 1, 1955, and I considered possible ways and means of bringing to a close the cases which these two commissioners had heard. I, of course, assigned them no more cases to hear. I obtained the consent of the parties in ten of the cases to transfer them directly to a judge. In several, the petitioner would not agree, and I left those cases with the commissioners.

The commissioner is required to make proposed findings of fact, which are served upon the parties; the case is then assigned to a judge and the parties can file objections and complete the filing of their briefs. It had been the practice of our judges to consult with the commissioner in regard to the objections filed and in regard to the decision of the case, for which latter purpose the judge might request a memorandum from the commissioner. I have limited the work of the commissioners to the finding of

the proposed facts, and the judges no longer consult with the commissioners. Undesirable though this is, I felt it was necessary as a means of getting these cases out of the hands of these commissioners. One of them, on July 1, 1957, still had five cases and, at the rate he was going, he would not get the last one out of his hands and into the hands of a judge for another two and one-half years. The other had 12 cases at that time, and it may be even longer until he finishes his findings of fact in those cases. The experience of the court with commissioners up to now does not encourage me to believe that "a more liberal use of commissioners" is desirable.

More judges not needed

Another suggestion with which I disagree is to increase the number of judges on the court. The Tax Court is an integrated court with nationwide jurisdiction, not 16 separate judges, each acting on his own, but a single, closely knit body of judges which endeavors to act consistently, following its own precedents, so that, insofar as is humanly possible, there will be one precedent rather than 16 different ones on a given question. Some of the means by which it accomplishes this desirable result are the review of all reports by the chief judge and the consideration of cases by the court as a whole in its court conferences, which take place practically every Friday. Any increase in production would *not* be in proportion to the number of additional judges. The review and administrative work of the chief judge would become oppressive. The number of cases requiring review by the full court would increase, thus taking additional time of all of the judges to study those cases, and the conferences, difficult enough with 16 judges, would become impossibly long and unwieldy without any compensating benefits. The appointment of more judges should be a last resort.

Additional law clerks unnecessary

Another suggestion is the employment of additional law clerks, including law clerks to attend the judges in the trial of the cases. This suggestion merits little consideration or comment. Most Federal judges have but one law clerk, while most of the Tax Court judges now have two, which is certainly plenty if the judge is to be the one to decide his cases. He needs no law clerk at the trial to assist him in any way, and, since months go by after every trial before the briefs are in and the judge can take up the case for decision, the law clerk's presence at the trial would serve no useful purpose. My policy has been to have but one law clerk at a time. That one has generally been a young man just out of law school. I use him for limited purposes only and never for the decision of a case. If anyone backing this proposal would care to look into it, he will find that my use of only one inexperienced law clerk has not adversely affected my production record.

Another suggestion is that the Tax Court should encourage and insist upon pretrial conferences, which other courts have used so successfully. The Tax Court has carefully considered this suggestion but has not adopted any rules on the subject. However, it has conducted such conferences and has never refused a request to conduct one. Also, the trial judge, with some success, occasionally suggests, at the calendar call before trial, his willingness to participate in a conference which might lead to a settlement, simplification of the issues, further stipulation of facts or saving of trial time in a case then about to be tried. A number of years ago when pretrial practice was new, I told members of the tax bar who were advocating its use to demonstrate its importance in tax cases by requesting pretrial conferences wherever appropriate, even in the absence of a Tax Court rule, but no one, to my knowledge, ever thereafter made such a request.

The explanation is that the Commissioner and the taxpayer have had conferences in most cases all along the line, and when the Tax Court sets a case for trial, the parties, stimulated by the rules of the court, use the intervening 90 days to conduct by themselves a wonderfully efficient and successful pretrial procedure without any loss of time by a judge of the Tax Court. I know of no other court so fortunate in this respect, and any change which might adversely affect this procedure would be most unfortunate. No judge of the Tax Court has a moment of spare time, but if it appeared that, under all of the existing circumstances, he could spend some of his time more profitably in pretrial procedures than in hearing and deciding those cases not settled or simplified without his participation, then, the Tax Court would insist upon such procedures, difficult as that might be on a nationwide basis.

Decisions from bench save no time

Another suggestion, springing from inexperience, is that a larger number of simple cases should be decided from the bench. The number of such cases is negligible. The decision of a case from the bench does not save the judge any time. The law requires him to file a written report (findings of fact and opinion, which the chief judge must review). A report in a simple case can be written very quickly in chambers and without any loss of time whatsoever. Announcement from the bench does not shorten the time devoted to the case or result in any greater production. Such cases present no problem. All judges of the court recognize this fact.

Another suggestion is "more vigorous effort on the part of the Service to work out settlements of the . . . Section 722 cases . . . pending in the Tax Court." This is the field in which the real work of settling cases takes place. It is not limited to Section 722 cases but includes all types of tax cases docketed in the Tax Court. The Tax Court wants to help all it can to have cases settled, and it can and does help materially. Experience has shown that most settlements are reached after the court has

Ceiling on Federal taxes?

CONGRESS has had bills introduced during the past several sessions looking to a constitutional amendment which would place a ceiling on Federal income tax rates. Two surveys taken in recent years throw some light on the public attitude toward such a proposal.

The first survey, which tested the appeal of a ceiling without reference to what other provision would have to be made to cover the loss in revenue, showed 53% in favor of the ceiling, 35% opposed, and 11% with no opinion. The second survey, taken over two years later and accompanied by reference to other kinds of taxes to make up the loss, showed 17% in favor of the ceiling, 68% opposed and 15% with no opinion.

These American Institute of Public Opinion (Gallup poll) figures appeared in the *Chicago Sun Times*, issue of July 14, 1957. ☆

FORM OF TAX COURT INQUIRY ON CASE STATUS

TAX COURT OF THE UNITED STATES
WASHINGTON

CLERK OF THE COURT
(Name of case)
Dear Sirs:

The above-mentioned case is docketed for trial at .....; and it may be reached for trial within the next six to eight months. This letter solicits needed information regarding the calendaring of that case for trial.

Please inform the Court, according to your best present judgment, with respect to the following matters:

1. Is settlement of the case between the parties without trial possible ....., probable ..... or improbable .....?

2. If the case is to be tried, may all ....., most ....., some ..... or none ..... of the facts be stipulated? (See Rule 31(b) of the Court's Rules of Practice)

3. Have any facts been stipulated ....., or what steps are being taken to stipulate facts? .....

4. Will the case be ready for trial when reached? Yes ..... No ..... If early trial is not appropriate, state why .....

5. What is your best estimate of the actual time required for trial of the case, in hours? ..... Hours.

The Court will expect a prompt return of this letter supplying the information requested. A copy of this letter is enclosed for your files.

By Order of the Court
Date reply prepared: .....
Signed: .....
Counsel for (Petitioner)
or (Respondent)

Very truly yours,
Howard P. Locke,
Clerk of the Court.

set a trial date. So the Tax Court sets as many cases for trial as it can and thus acts as a sort of catalytic agent in producing the settlements. Catalysis is defined as "acceleration of a reaction produced by a substance, the catalytic agent, which may be recovered practically unchanged at the end of the process." That fits the situation pretty well. The very presence of the Tax Court thus assists the process of settlement between the Commissioner and the taxpayers.

Settlements further stimulated

The Tax Court has recently adopted two practices which should further stimulate settlements. One is to send an inquiry to both parties six months prior to the anticipated trial date. Some cases are settled before they are set for trial, and these new inquiries may tend to increase that number. The inquiry is in the form illustrated above.

The other new practice is to serve the trial notices on the parties 90 days ahead of the trial date instead of 60, as formerly. The office of the chief counsel favors this, believing that the extra time will enable the Service to contact more taxpayers and their counsel and negotiate more settlements. The sending of the trial notices 90 days in advance is not as simple as it might seem. The difficulty is in obtaining commitments that far in advance for the use of a particular courtroom. The Tax Court has its own courtrooms in only three of the cities and must borrow courtrooms in the other 47 or more cities where it regularly holds court. Courtrooms in many of these places are scarce, and those in charge frequently cannot safely say that far in advance that a room will be available. Nevertheless, the Tax Court is making a vigorous effort to meet the 90-day deadline.

Section 722 cases

Section 722 cases have been a problem, but they are no longer being docketed, and they have been going off the list of pending cases, for some time now, at the rate of about 160 a year. The number not yet set for trial is now down to about 245. The Tax Court has set Section 722 cases on its regular calendars during recent years, and the Service is making greater and more successful efforts to settle those cases than was true some years ago. The remaining Section 722 cases will be disposed of probably during the next two or three years at the latest.

Pending cases

The number of cases pending before the Tax Court rose at one time to over 22,000, and was reduced at another to 4,419. The principal concern about the number of pending cases seems to be the amount of time elapsing between docketing and decision. The court does not want cases to be too long in its hands. However, it should be borne in mind that that waiting period undoubtedly contributes to the settlements. The parties need a period to think things over and, if necessary, to cool off. There would be far fewer cases settled if the court were ready to try every case the moment it became "at issue." The court receives relatively few requests for early trials. Interest on the ultimate amount to be paid or refunded can be a softening factor in this connection. Both parties are generally content to allow their cases to await their turns for trial, and, in many instances, they advance reasons for delaying the trial. Naturally, the Tax Court is concerned about any increase in the number of its pending cases and is pleased to see a decline. Statistically, 6,000 looks better than 10,000, but just what practical difference there is between the two is not too clear.

Tax Court's purpose

What is the Tax Court, what is it supposed to do and what can it be expected to do in the Federal tax field?

It had its beginning in the Revenue Act of 1924, but its character and its method of operation stem from the Revenue Act of 1926. There have been no substantial legislative changes since then, except for changes in name and titles. The original intention of the Treasury Department in 1924 was to create a Board of Tax Appeals within the Treasury to use informal procedures to settle tax cases in quantities. Congress, instead, created a court, although, unfortunately, it left it with the tag of "an independent agency in the Executive Branch of the Government." The Tax Court exercises only judicial functions, and the proposal originally made in 1926 to do away with this misleading and troublesome agency label, now too long delayed, may possibly become a reality as a result of legislation now being prepared.

The original purpose of the court was, quoting Alex Gregg, representing the Treasury in 1926, to "establish precedents, the latter not for its value in deciding the cases which would be presented to it, because they necessarily must be limited in number, but for the purpose of establishing precedents to

guide the Bureau in the settlement of other cases and to guide the taxpayer in disposing of his case." It was then recognized that the "court" was accomplishing the tasks assigned to it.

The Tax Court of the United States is an integrated court consisting of 16 judges, one of whom it elects as its chief judge at least every other year. It has been assisted in recent years by the voluntary recall of several of its retired judges. What may not be fully realized is that it has a great deal of work to do besides that of merely deciding cases. It has, in addition to the judges, about 135 employees with whom to perform all the necessary functions of a court. This is a fairly big job. The chief judge is in charge of all administrative matters. Petitions and all related documents must be carefully docketed and filed, trial calendars must be constantly arranged, courtrooms must be borrowed well in advance in all but three of the 50 or more cities where trials are held, a judge must be selected for assignment to each calendar, the reporting and publications of the opinions must be attended to, records must be prepared for appeals, budgets must be made up and approved and appropriations obtained. The chief judge is assisted in these and other administrative functions by the clerk of the court and by the administrative officer of the court, each of whom supervises about 30 employees. There are under the clerk of the court a docket, records and calendar section, a docket file section, an appellate section and four deputy clerks to handle the circuit calendars. There are under the administrative officer a fiscal office, a general services section, a library, a reporter's office and a statistical section. The other employees, about 75 in number, are assigned directly to the individual judges.

An individual judge hears and decides each case assigned to him by the chief judge, and the latter then reviews the decision submitted by the individual judge. This requires care and study. The chief judge may be able to make valuable suggestions such as changes to improve or properly limit the decision, and he tries to prevent conflicting opinions from going out. He can direct that any opinion be reviewed by the full court, if he deems it appropriate.

The foregoing touches only some of the high spots, but it may serve for present purposes.

Experience has shown that Mr. Gregg knew what was desired and what could be accomplished when he said in 1926 that the number of cases which the court could decide would be limited. The Tax Court was not intended to be, is not, need not and should not be a quantity-production tribunal. This should be borne in mind.

Tax Court performance

Of course, the total number of cases that have come to the Tax Court, and the amounts and problems involved, make a rather imposing picture. A total of 182,249 petitions were filed from the beginning up to July 1, 1957. These involved total deficiencies of over $7,069 million. Of those cases, 171,573 have been closed; and the total of the deficiencies determined in the closing was about $1,960 million. However, the Tax Court had no direct part in the closing of most of those cases. Instead, over two-thirds were closed by agreement between the Commissioner and the taxpayer. It was essential to the continuance of the Tax Court that those settlements should take place. Taxpayers should always remain alert to the possibility of settlement, even after trial and despite earlier failures. I don't think there is any practical way for the Tax Court judges to decide any substantially larger portion of such controversies, and, furthermore, I do not think it is desirable or necessary that they should. The number of written opinions has averaged around 600 a year, and they close about 850 docket numbers a year. That represents a lot of work. Any increase in the number of cases which the judges of the Tax Court might decide would be inconsequential in any event. A very little change in the success of the Service and the taxpayers in settling cases can make an overwhelming change so far as the Tax Court is concerned. Should the percentage of settlements go down even slightly, the Tax Court would be swamped, and if it could be improved slightly, the Tax Court would have no serious problem of pending cases.

The total number of cases settled exceeded the total number of new cases docketed during the period of July 1, 1953, to July 1, 1956. This reduced the number of cases pending before the Tax Court from 12,889 to 9,908; but in the fiscal year ended June 30, 1957, 5,259 cases were docketed while only 4,645 were closed, and 144 were reopened. Thus, the number of pending cases increased to 10,666 at June 30, 1957. I have called this change in trend to the attention of the Commissioner in the hope that he may be able to do something about it, since, as I have already indicated, the Tax Court is not able to increase substantially its rate of decision or otherwise effect a substantial change in quantity. The Commissioner replied that steps are already being taken to reverse this trend.

That the Tax Court is continuing to serve a good and useful purpose and has fulfilled the intentions of its creators is nationally recognized. Its constantly renewed work load demonstrates its popularity with taxpayers. Over five-sixths of all Federal tax cases are brought to the Tax Court. Its judges work hard, intelligently and effectively at their never-ending tasks. ☆

Methods of improving audits performed by IRS agents discussed

One of the topics that drew many questions from the floor (and sparked much comment over lunch) at the recent Tax Institute Symposium in Princeton on Income Tax Differentials was a rather small section of the paper by Stanley S. Surrey on the income tax base for individuals. Mr. Surrey, well-known lawyer and professor of law at Harvard Law School, is noted as a trenchant critic of inequities in our tax structure and in his Princeton talk extended his range to defects in enforcement—specifically, the superficial audit performed by some revenue agents.

Mr. Surrey stated that "he did not have first-hand knowledge of the situation, but was drawing on comments made to him by accountants. He presented the observations in the hope discussion would indicate just how effective the present audits are, and how matters could be improved. He suggested that the agents themselves would benefit from a consideration of these matters, since their time would be spent more effectively."

CPAs in the audience, aware of the

time-consuming and expensive nature of the thorough audits they perform, felt that the observations were stronger than conditions warranted, though most agreed that, if agents could spend more time and were required to carry out some of the procedures of professional auditors, the result would be greater equity as between taxpayers.

Mr. Surrey said: "The translation of statutory rules into actual tax burdens depends upon the effectiveness of taxpayer compliance and tax administration. While present voluntary compliance is apparently quite high—perhaps in excess of 90% overall—the gap between perfection and the present result is considerable. One estimate places unreported adjusted gross income at $26.5 billion. Though perfection is not attainable, there is certainly room for improvement.

"Withholding [as suggested on interest and dividends] and detailed reporting together cannot close the gap caused by noncompliance. Resort must always be had to the corrective results of investigations and audits by revenue officials. It is difficult to judge the effectiveness of the current enforcement activities of the Service and of the general work of the revenue agents. There are many who feel that the skills of the Service have not kept pace with the growing complexity of tax law and tax-motivated transactions. Thus, there is real doubt that agents in checking returns are exhibiting the insights and detailed digging necessary to effective audits. The following observations have been made:

"1. Many agents are susceptible to "bait" items, so that taxpayers are leaving a few obvious errors to draw attention away from more serious items. Thus, the repair account may be kept relatively clean except for a few bait items. But once the agent has taken this bait, the other accounts are not examined.

"2. Agents often fail to pursue obvious leads. Thus, they do not ask for the long-term audit reports that may be present on a certified audit; here they could find discussion as to the factors justifying the taxpayer's own reserve for taxes and any cushions therein. They do not scan the corporate minutes. They do not review the year-end adjustments that may have been required of the taxpayer by an accounting firm after its audit; such a step would indicate which transactions or accounts the accounting firm found questionable. Thus, if year-end adjustments require the capitalization of some repairs, then there may be other problems in the repair account. They only talk to the head man and not to lesser employees, who may have more detailed knowledge of the taxpayer's accounting system.

"3. Agents often fail really to acquaint themselves with the taxpayer's accounting techniques. Thus, if they found how representative transactions were actually handled, they would then know which leads to follow. If 50 consecutive vouchers were traced through, soft spots in the accounting system might well show up. If inventory account sheets were scanned, the gross distortions in pricing methods would appear. The company's chart of accounts should likewise be scanned for unusual transactions.

"4. Agents often neglect the details in the cost-of-goods-sold accounts. Yet many a doubtful item can be buried there. An agent may look at officers' salaries, but not find the compensation paid to a vice president in charge of production buried in cost of goods sold. Repairs that should be capitalized may be handled instead as plant supplies. Travel and entertainment may be in plant overhead. These accounts in cost of goods sold are detailed and it apparently takes a skilled and hard-working agent to work through them. And of course other approaches must be used—thus the expenses of obtaining and maintaining a company yacht could be scattered in small amounts among many accounts and hardly noticed, yet a scanning of the names of vendors to the company might readily disclose the purchase of the yacht.

"5. Agents are often guided in their audits by the classifications on the tax return. But these classifications, many made for statistical purposes of the Service, are obviously not suited to all businesses. Different businesses require different audit techniques.

"6. There are, of course, overriding factors such as a willingness to work, a sense of what is material, a feel for the significant, a consistency in approach.

"Some of the above points may be wide of the mark, and there may be others to add. But to many this appears to be a troubled area. And there is also the problem of the return not audited. Has the number of agents kept pace with the growth in the number of returns and complexities of tax law?

"A real public service could be performed by the American Institute of Certified Public Accountants and by the American Bar Association Section of Taxation if they would appoint select committees to consider the specific areas in which agents are not performing their tasks efficiently and to report their conclusions to the Service. The inquiry would concern the kinds of situations and transactions as to which agents do not uncover taxpayer errors or malfeasance to the extent they should, as well as matters in which agents are over-zealous to the point of inefficiency or abuse of authority. Such informed guidance as to needed improvement in present performance would be of immense aid to adequate and proper enforcement of the tax laws." ☆

New procedural decisions this month

Amended petition insufficient to open barred year. In a timely petition taxpayer intended to appeal deficiency assessments for 1944, 1945, and 1946. However, he omitted to include 1944 in his petition and later sought to correct the error by an amended petition filed after the expiration of the 90-day statutory period. Originally the Tax Court refused to dismiss the amended petition, reasoning that the petition gave rise to one cause of action, and the amendment referred to that one action. Upon reconsideration of the law, the court now rules that the deficiencies for the separate years gave rise to separate causes of action, and that once a cause of action is barred by statute, it cannot be asserted by an amended petition. Accordingly, the original motion of the Commissioner to dismiss the proceeding as to 1944 is granted. *Krome,* 1957 D No. 14775.

Extension of time for collection doesn't extend time to file refund claim. The court dismissed taxpayer's refund suit on the ground that his refund claim was filed too late. He argued that an offer in compromise which waived the benefit of the statute re "assessment and/or collection," extended his time for filing a refund claim. The court agrees that an extension on assessment does under the Code extend the time for refund. But this offer, it finds, extended merely the time for collection and such an exten-

sion has no effect on refund claims. *Hill,* DC Fla., 9/12/57.

No interest on loss carryback refund; no claim made. Taxpayer had taxable income in 1952 but an operating loss in 1953. On filing the 1953 return, he also made application for a tentative refund. Due apparently to delay in locating the returns, the IRS was unable to process this application within the statutory period and rejected it. Taxpayer made no further claim but on regular examination was allowed the carryback and received a refund but without interest. On this suit for interest, the court holds none is due. *Jernigan,* DC Texas, 9/30/57.

Interest allowed though taxpayer claimed carryback from wrong year. In 1944, taxpayer filed a claim for refund of 1941 excess profits tax based on carryback of an unused excess profits credit for 1943. On examination, a revenue agent determined there was also an unused credit for 1942 which he applied against the 1941 tax. The statute provides for interest on a carryback refund commencing one year after a refund claim is filed. The court holds that taxpayer's claim, though based on a carryback from the wrong year, is sufficient to start the running of interest because it properly advised the Service of a claim for refund of 1941 tax and the reason therefore. *U. S. Pipe & Foundry Co.,* Ct. Clms., 10/9/57.

Compromising with one joint obligor doesn't release others [*Certiorari denied*]. Taxpayer and others were assessed taxes and penalties of $47,000 for operating an unbonded distillery. The Seventh Circuit held that the compromise, made with one of the jointly and severally liable parties, specifically provided that claims against the others were unaffected. Taxpayer argued that a release of one was a release of all. The court held that since the Government has the power to proceed against the taxpayer for the entire amount, it can proceed for a lesser amount after a partial collection in compromise with another. The court requires a saving clause; the offer in compromise must state that the obligations of others will not be affected. The court did not discuss the effect of the compromise on this taxpayer's right of action against his co-obligor, who had here paid $5,000 in the compromise offer. *Wainer, cert. den.* 10/14/57.

Mandamus not proper remedy to collect overpayment. A deficiency was asserted against taxpayer and it filed a petition with the Tax Court. After prolonged negotiations the case was settled on stipulation that a refund was due for certain years. The IRS refused to refund the overpayment on the ground that taxpayer was liable for deficiencies assessed against some related corporations. Taxpayer then brought this mandamus action to compel the Commissioner to refund the stipulated overpayment. This court affirms the dismissal of the action without the prejudice to any other action appropriate for the collection of the overpayment. Mandamus is not proper relief because taxpayer has a complete remedy in the form of an ordinary suit for refund. In this suit the Commissioner can assert any defenses to the refund. *Empire Ordnance Corp.,* DC Cir., 10/17/57.

United States is proper party in suit to recover Guam income taxes. Taxpayers are U. S. citizens temporarily employed as construction workers in Guam. They are suing to recover Guam income taxes, based on the Code's exemption for income earned in a possession of the United States. The Organic Act of Guam provides that all income tax laws in force in the U. S. shall be in force in Guam, but that the taxes collected shall be paid into the treasury of Guam for its benefit. The court holds that this was not a provision for a separate income tax for Guam. The tax is part of the U. S. tax structure, paid into Guam for convenience, but the U. S. owns the proceeds of the tax. Therefore, it is a proper party in a suit for refund. One dissent: under the Organic Act, the U. S. Treasury was never entitled to the revenue. *Jennings,* Ct. Clms., 10/9/57.

Procedure outlined for granting extensions to U. S. citizens working abroad. A uniform procedure has been prescribed for granting extensions of time for filing income tax returns to U. S. citizens residing abroad who expect to qualify for exemption of earned income by reason of a bona fide foreign residence for an uninterrupted period which includes a full taxable year, or by reason of physical presence abroad at least 510 days of any 18 consecutive months. Applications for an extension are to be submitted in triplicate on Form 2350 and will normally be approved for a period ending 30 days after the date on which taxpayer may reasonably be expected to qualify for the exclusion. *Rev. Proc.* 57-33.

IRS failure to send notice to attorney doesn't excuse late filing. Some time prior to 1956 taxpayer filed a power of attorney with the Commissioner requesting that all communications with reference to 1951 be sent to their attorneys. On 2/11/57, the Commissioner sent taxpayer a statutory notice of deficiency for 1951 but failed to send a copy of the notice to the attorneys, although a copy of the statement attached to the notice was. More than 90 days later, on 8/19/57, taxpayer moved for leave to file a petition. The court holds that the failure to follow taxpayer's request and send a copy of the notice to the attorneys in no way affects the 90-day period in which a Tax Court petition must be filed. Since the petition wasn't filed within the 90 days, it is untimely and can't be considered. *Allen,* 29 TC No. 15.

Petition received after 90 days and lacking postmark date untimely. Taxpayer's petition was received by the Tax Court 14 days after the 90-day period had expired. The court dismisses it as untimely in spite of taxpayer's claim that he placed the petition in a U. S. mail box before expiration of the 90 days. The rule that "the date of postmark is deemed the date of delivery" holds true only if there is a date stamped on the envelope. Since there was no postmark date on taxpayer's petition, the court considers the rule inapplicable. The general rule applies that the petition must be filed (received by the Tax Court) within 90 days. *Madison,* 28 TC No. 154.

Amended forms may be used for refund claims. The IRS points out that the Regulations provide that claim for refund may be made either on Form 843 or 1040 or "an amended return." A valid claim for refund may be made on an amended Form 1041, in the case of an estate or trust, or on an amended Form 1120, in the case of a corporation. *Rev. Rul.* 57-501.

Public inspection of offers in compromise. Certain accepted offers in compromise will be available for public inspection for a period of one year at the national office (for offers accepted there) and at the offices of each District Director (for offers accepted at the district level). *Rev. Proc.* 57-30.

TAXATION OF

Partnerships

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA

How to determine basis of partners' interest from conventional accounting records

by **B. S. MOTHERSHEAD**

Accountants serving partnerships face a very difficult problem in designing records that will enable them to prepare both conventional accounting statements the partners (and banks and other third parties) need and comprehend as well as computations of the partners' bases for their interests. Mr. Mothershead outlines here a system which he has used with considerable success in handling clients' affairs (and, incidentally, in instructing assistants in the meaning of Subchapter K). We are planning to bring you later papers detailing the application of this method to other problems—here Mr. Mothershead is concerned mostly with the formation of the partnership and the treatment of contributed property.

Subchapter K of the 1954 Code, containing the partnership provisions, has presented a definite challenge to the accounting profession. In our development of accounting principles as applied to the accounting for partners' equities in partnerships we have been satisfied with the acceptance of the partners' capital accounts as the measure of their financial position with reference to the partnership. We have failed to observe the analogy between an equity in a partnership and an equity in any other type of asset.

In accounting for ownership in real estate, we have placed much emphasis on the requirement that our accounting disclose both the total cost of the asset and the remaining purchase obligation or other liability against it. But the application of this principle to a partner's interest in a partnership has received little, if any, attention. Now we are confronted with the provisions of the Internal Revenue Code and Regulations, related to partnerships, requiring us to give special treatment to the liabilities of the partnership in accounting for partners' basis in their partnership interest. (Section 752).

Another important, though less frequent situation spotlights the difference between generally accepted accounting principles and the requirements of the 1954 Code. This is where properties contributed to a partnership by a partner at values different from his adjusted basis, are recognized by the partnership. It is not unusual for one partner to contribute certain assets which have a very low basis in his hands, due either to having been acquired before general price increases or to the use of maximum allowable depreciation rates in prior years. The partnership accepts the asset at the current real value, which may be somewhat greater. Since there is a valid transaction to establish the value for accounting purposes, we have not hesitated to recognize the values at which the assets are contributed.

Basis under 1954 Code

The 1954 Code takes a different view in holding that, for purposes of income tax accounting for the partnership, the basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partners. (Section 723). Likewise, it sets up very specific rules for determining each partner's distributive share of depreciation, depletion, or gain or loss with respect to such contributed property. (Section 704(c)).

On first examination of the 1954 Code, it would seem that either a revision of generally accepted accounting principles with reference to these two matters will be necessary, or that two sets of books for a partnership will be required. One set of books would give effect to the terms of the partnership agreement under generally accepted accounting principles and the other would give effect to the special rules of the Code.

On further consideration it is realized that practical application requires that there be no revision of generally accepted accounting principles in these two areas of apparent confusion. As to liabilities of the partnership, which may fluctuate from day to day, obviously it would be unnecessarily burdensome to incorporate into day to day accounting for partners' interest every transaction increasing or decreasing such liabilities. This difficulty is recognized by Regulation Section 1.705-1 in the statement: "A partner is required to determine the adjusted basis of his interest in the partnership only when necessary for determination of his tax liability or that of any other person." The difficulty with this statement lies in the fact that in many situations, some of which may be entirely unexpected, whether or not there is a tax effect can be known only after the partners' adjusted basis is known. Therefore the Regulations hasten to mention some of the situations where the determination should be made as a regular procedure. But the taxpayer, or his accountant, is left to devise his own methods of such determination.

Further practical reasons make it inadvisable to keep the books of the partnership to reflect the tax recognized basis of contributed property rather than the values recognized in the partnership agreement. A single attempt (to keep partnership books strictly in accordance with these provisions of the Code, where the partners have recognized values considerably different from the contributing partner's adjusted basis, and then to explain to them the resulting profit and loss statement and partners' capital accounts) is sure to make the accountant realize the practical difficulty. After such an experience, he is sure to go back to our generally accepted accounting principles for the

[B. S. Mothershead is a CPA and member of the Harlingen, Texas, accounting firm of Mothershead, Simpson & Hamilton.]

basic books, and seek some other method of meeting the requirements of the Code.

Therefore the alternative would seem to be to keep two sets of books, one for the partners' information applying ordinary accounting methods in accordance with the partnership agreement, and the other giving effect to all of the confusing and seemingly irrational rules of subchapter K of the Code of 1954. But what would the accountant's answer be, on cross examination in the Tax Court, to the question: "Will you try to explain to the court the real purpose of the taxpayer in keeping two sets of books, one to advise the partners of their real position, and another to use in making their tax returns?" We quickly decide it would be inexpedient to keep two sets of books.

Then what are we to do? The answer was slow in coming to the writer until he realized that he, along with many other accountants, was confusing two distinct although related concepts: i.e., partners' capital and partners' basis. That there are two distinct and separate concepts is clearly indicated in the Regulations. (See Section 1.704-1(c) (3)). This leads to the thought that "partners' capital" is a financial accounting concept, while "partners' basis" is an income tax accounting concept. Again we feel justified in our decision to keep the books (just one set, if we may) according to generally accepted principles for financial accounting, and then devise a means of arriving at "partners' basis" at any given time from the results thus obtained.

Worksheet to derive bases

It is found that this is not as difficult as it at first appeared. The writer has developed a "work sheet" form of "analysis of basis of partners' interests", which, when used under a few simple rules, can be developed for a partner at any particular time that it may be "necessary for the determination of his tax liability or that of any other person." An example of this work sheet is presented as Exhibit III. This type of analysis has been found useful, not only in arriving at a partner's basis under any particular set of facts, but also in gaining a clearer concept of subchapter K and realizing that what seemed at first to be a confusing and conflicting set of rules is in fact a well integrated and clearly defined pattern. The writer will present in the remainder of this article a general explanation of this form of analysis, an example of its use and a statement of the general rules required. In subsequent articles the application of this method to the various situations and examples given in the Regulations under subchapter K will be presented, such as special situations in the formation of partnerships, taking in new partners, transfer of partners' interest, withdrawals by partners, liquidation of a partner's interests, and dissolution of the partnership. Referring to Exhibit III, it will be noted that the first seven columns relate to the ordinary books of account of the partnership, presenting in summary form the basic factors required in determining the relationship between partners' capital accounts and basis of partners' interests. It is found necessary to provide two columns for the assets of the partnership, the first relating to the "basis" value of the partnership assets as recognized by subchapter K, and the second relating to such "nonbasis" values as are reflected in the books of the partnership kept in accordance with the partnership agreement using generally accepted principles for financial accounting. Also, it is necessary to have one column for liabilities and one column for the profit and loss account as reflected by the normally kept books of the partnership. The next three columns (or as many columns as there may be partners) are used to reflect the partners' capital accounts as contained in the regular books of account of the partnership, without reference to the provisions of subchapter K. The remaining columns are used to reflect the basis of partners' interests under the rules of subchapter K, reflecting the changes in basis resulting from specific transactions or summaries of transactions and the balances at the end of the accounting period.

We now will take up the specific example which is illustrated by Exhibits I, II, and III. Exhibit I presents comparative balance sheets for the A B C Partnership for the first two years of its operation, while Exhibit II is a comparative operating statement covering these two years. Only the essential elements for the purposes of the problem are shown in each of these exhibits. However, the application could as well be made from much more elaborate balance sheets or operating statements.

Transactions on Exhibit III

We now will take Exhibit III and discuss the application of these transactions or results of the years' operations on the basis of partners' interests as reflected therein, taking the numbered lines in order.

1. The cash contributed by A increased the partnership assets and total capital. It also served to increase A's capital account as well as the basis of his interest in the partnership.

2. Since the fixed assets contributed by B had a net basis in his hands of $30,000 we will show as an addition to the basis of B's interest, the amount of $30,000, and also place this amount in the partnership assets "basis values" column.

FACTS IN THE EXAMPLE

Partners A, B, and C, agreed to enter a partnership with their capital accounts and participation in profits and loss to be equal. A agreed to contribute $10,000 in cash. B agreed to contribute a factory building with equipment having a present value of $40,000 subject to a mortgage of $30,000. The estimated average remaining life of this building and equipment was set at 30 years with no anticipated salvage. This factory building and equipment actually had an adjusted basis in B's hands of $30,000. C agreed to be the active manager of the business and to receive an annual salary of $10,000. However since he had no cash to advance it was agreed that his first year's salary would be credited to his capital account at the end of the year as his contribution to the partners' capital. Thereafter his salary was to be paid in cash. The results of the first two years' operations, as well as the financial position at the end of each of the two years, are reflected in Exhibits I and II. These exhibits were prepared from the books of account kept under generally accepted methods of financial accounting. No effort was made in the books of the partnership to reflect the effect of subchapter K on either the basis of the assets to the partnership or the basis of partners' interests.

EXHIBIT I: A B C PARTNERSHIP COMPARATIVE BALANCE SHEET

	Beginning of Partnership	*End of First Year*	*End of Second Year*
Assets:			
Cash	$10,000	$10,000	$10,000
Receivables		10,000	11,666
Inventories		10,000	10,000
Factory building and equipment	40,000	40,000	40,000
(Reserve for depreciation)		−1,333	−2,666
Total Assets	$50,000	$68,667	$69,000
Total Liabilities	$30,000	$45,000	$33,000
Partners' Capital:			
A	$10,000	$ 7,889	$12,000
B	10,000	7,889	12,000
C		7,889	12,000
Total Liabilities and Capital	$50,000	$68,667	$69,000

3. Since for purposes of the partnership agreement, these fixed assets were treated as having a value of $40,000, which is $10,000 in excess of the net basis of the properties to B, this $10,000 difference will be treated as "nonbasis values" in connection with the partnership books and the $10,000 amount placed in the second column. The effect on the partners' capital accounts will be covered in discussion of line 6.

4. Since the property contributed by B to the partnership was subject to a mortgage of $30,000, B was relieved of the individual liability thereof in the amount of $30,000. Under Code Section 752 this is treated as though B had received a distribution of $30,000 in cash, for purposes of determining the basis of his interest. Thus we place a minus amount of $30,000 in B's "basis of partners' interest" column.

5. Since the partnership accepted the property subject to the $30,000 mortgage (whether it assumed payment thereof or not) the three partners are treated as having become individually liable for one-third of the total amount. Therefore under the provisions of Section 752 each of the three partners, for the purpose of determining the basis of their interest, will be treated as having contributed $10,000 to the partnership. (It has been found desirable for purposes of clarity to show separately the two elements involved where an individual partner's separate liability as well as the partnership joint liability is affected by the same transaction).

6. As far as the books of the partnership are concerned the only entry on capital accounts is to show B's net contribution of $10,000, being the excess of the market value of the contributed properties over liabilities against them.

7. Since C is to contribute a year's salary as his capital to the partnership no entry is made of this either on the books or in connection with the accounting of the basis of partners' interests until the end of the year.

8. When C's salary has been earned and available to him without restriction, an entry is made on the books charging the salary expense account and crediting A's capital account. Likewise, since this will be treated as a guaranteed payment to C of $10,000 and therefore reportable by him as taxable income, the basis of his interest in the partnership will be increased by $10,000. (Regulations Section 1.721-1(b)(1)).

9. In view of the estimated remaining life and salvage referred to in the statement of the problem, the amount of depreciation on the building and equipment as reflected by the partnership books is found to be $1,333. However, inasmuch as only $1,000 of this depreciation may be taken into consideration for income tax purposes, the difference of $333 will be set over into the nonbasis value column with reference to the partnership assets.

10. We find that the balance sheet at the end of the first year shows the total liabilities to be $45,000 which is $15,000 greater than reflected by the analysis up to this point. Therefore the $15,000 amount is shown as an increase in liabilities in the analysis. An increase in liabilities of the partnership is treated under Code 752 as being the equivalent of the payment into the partnership by the partners of their individual parts of such liabilities. We show one-third of this increase of total liabilities as an increase in the basis of each partner's interest.

11. A tentative footing of the two asset columns in the analysis shows a total of $48,667. Since the total assets at the end of the first year as reflected by the comparative balance sheet is $68,667, we enter in the basis values column the difference of $20,000. Referring to the operating statement (Exhibit II) we find that, except for C's salary and the depreciation, which has already been charged to profit and loss, the net op-

EXHIBIT II: A B C PARTNERSHIP COMPARATIVE OPERATING STATEMENT

	First Year	*Second Year*
Net Sales	$ 56,000	$112,000
Less cost of sales	37,333	74,667
Gross profit	$ 18,667	$ 37,333
Expenses:		
Salary of partner C	$ 10,000	$ 10,000
Depreciation	1,333	1,333
Other expenses	13,667	13,667
Total expenses	$ 25,000	$ 25,000
Net operating profit or loss	$ −6,333	$ 12,333
Allocation of Net Profit or Loss to Partners:		
A	$ −2,111	$ 4,111
B	−2,111	4,111
C	−2,111	4,111
Totals	$ −6,333	$ 12,333

erating profit for the year is $5,000, which amount we enter as a credit to profit and loss. Incidentally this $5,000, plus the $15,000 increase of the liabilities, equals to $20,000 increase of assets.

12. From the comparative operating statement we ascertained that there was a net operating loss for the first year of $6,333, which is divided equally on the books between the three partners. However, for income tax purposes we recall that we found on line 9 that $333 of the depreciation was not allowable for income tax purposes. Since no election had been made under the provisions of Code Section 704 (c) the resulting net loss of $6,000 for income tax purposes is also divided equally to reduce the basis of each partner's interest in the amount of $2,000 each.

13. On striking a balance on the analysis we find the total of the partnership assets basis values was $59,000 and the nonbasis value $9,667. These two figures added together agree with the total assets reflected by the standard balance sheet. We find that the total of liabilities and the total partners' capital agrees with the balance sheet. Also it is noted that the total of the basis of the three partners' interests agrees with the total of the "basis value" column of assets on the partnership analysis in the amount of $59,000. This equation will be made the subject of one of our general rules as stated later.

Second year

• 14. We now move into the second year's operations and on line 14 we note that there were no shifts in either the partners' capital accounts or the basis of partners' interests by reason of transactions occurring during the year.

15. We note on line 15 that, since C's salary was paid in cash, it is now entered as a credit in the "basis values" column.

16. The depreciation on the building is handled in the same manner as it was handled for the prior year as indicated on line 9.

17. The decrease in total liabilities for the year is entered in the partnership liabilities column, and under the rules stated in Section 752 of the Code, this decrease in liabilities is treated, for purposes of the effect on partners' interests, as though each of the partners had withdrawn their prorata part, thus reducing the basis of their interest in the amount of $4,000 each.

18. The increase in total assets as reflected by the balance sheet at the end of the second year (after allowing for the payment of C's salary and depreciation for the year) is entered in the partnership assets "basis values" column. Again we enter in the profit and loss column the amount of the net profit for the year before deducting the items already charged to the column. Also we find the amount equal to the sum of the increase of assets and the decrease of liabilities.

19. Inasmuch as the operating statement reflects the net operating profit of $12,333, the prorata part of this amount is credited to each of the respective partners' capital accounts on the books of the partnership. However for purposes of accounting for the basis of partners' interests, we recognize the fact that their distributable share of partnership income is increased by the depreciation noted in the nonbasis column. Accordingly the distributable operating profit for tax purposes is $12,666, of which amount $4,222 is distributable to each of the three partners. If election had been

EXHIBIT III: A B C PARTNERSHIP ANALYSIS OF BASIS OF PARTNERS' INTERESTS

		Basis Values	*Non-Basis Values*	*Liabilities*	*Partnership Profit and Loss*	*Partners' Capital Accounts A*	*B*	*C*	*Basis of Partners' Interest A*	*B*	*C*
FIRST YEAR:											
Initial Contributions:											
1. Cash by A		$10,000	$	$	$	$10,000	$	$	$10,000	$	$ ....
Factory building & equipment by B:											
2. Net basis to B	$30,000	30,000	....	....	....	....	....	....	....	30,000	....
3. Valued at	40,000	....	10,000	....	....	....	....	....	....	....	....
4. Mortgage	30,000	....	....	30,000	....	....	....	....	....	—30,000	....
5.	....	....	....	....	....	....	....	....	10,000	10,000	10,000
6. Net equity	10,000	....	....	....	....	....	10,000	....	....	....	....
7. Years salary by C	10,000	....	....	....	....	....	....	....	....	—0—	....
First year's operations:											
8. C's salary applied: (guaranteed payment)		....	....	....	—10,000	....	....	10,000	....	....	10,000
9. Depreciation on building		—1,000	—333	....	—1,333	....	....	....	....	....	....
10. Increase in liabilities		....	....	15,000	....	....	....	....	5,000	5,000	5,000
11. Increase in other assets		20,000	....	....	5,000	....	....	....	....	....	....
12. Net operating loss		....	....	....	6,333	—2,111	—2,111	—2,111	—2,000	—2,000	—2,000
13. Balances at end of first year		$59,000	$ 9,667	$45,000	$ —0—	$ 7,889	$ 7,889	$ 7,889	$23,000	$13,000	$23,000
SECOND YEAR:											
14. No shifts in interest											
Second year's operation:											
15. C's salary paid in cash		—10,000	....	....	—10,000	....	....	....	....	....	....
16. Depreciation on building		—1,000	—333	....	—1,333	....	....	....	....	....	....
17. Decrease in liabilities		....	....	—12,000	....	....	....	....	—4,000	—4,000	—4,000
18. Increase in other assets		11,666	....	....	23,666	....	....	....	....	....	....
19. Net operating profit		....	....	....	—12,333	4,111	4,111	4,111	4,222	4,222	4,222
20. Balances at end of second year		$59,666	$ 9,334	$33,000	$ —0—	$12,000	$12,000	$12,000	$23,222	$13,222	$23,222

made for treatment under Code Section 704(c)(2), the total amount would be distributed $4,444 to B but only $4,111 to each A and C.

20. The balances of the analysis at the end of the second year are found to agree with the balance sheet kept on financial accounting principles and the total of the basis of partners' interests is again found to agree with the total of the partnership assets "basis values" as reflected by the analysis.

The basic rules

From the foregoing example we readily can determine some basic rules for use in connection with this form of analysis, which we will state as follows:

(I) In accordance with Code Section 723, when properties are contributed to a partnership by a partner, (other than by a sale qualifying under Code Section 707(a)), such assets should be shown in the partnership assets "basis values" column at the same figure as the adjusted basis to the contributing partner. Any excess of the value over the partner's adjusted basis recognized by the partnership in its accounts should be placed in the "nonbasis values" column of the partnership assets. Likewise any depreciation, depletion, or loss or gain on disposition of such assets should be allocated between the "basis values" and "non-basis values" columns in proportion to the balances of such assets remaining in the two columns.

(II) Under Code Section 722, the entry in the columns for the "basis of partners' interests" shall be the amount of any money contributed and the adjusted basis in their hands of such other property as is contributed by the partners (without any offset for liabilities). Likewise the distribution of any profits or losses of the partnership to the respective partners, for the purposes of computing the basis of partners' interests, must be adjusted for the proportionate part of such depreciation, depletion, or loss or gain on disposition of assets as relates to the non-basis values of such assets as reflected on the partnership books, in accordance with the provisions of Section 704(c).

(III) Section 752 provides that any decrease of a partner's individual liabilities by reason of their assumption by the partnership or any decrease of the partner's share of the partnership liabilities shall be treated as though there was a distribution of money to such a partner by the partnership. Likewise Section 752 provides that any increase of a partner's individual liabilities by reason of his assumption of partnership liabilities, or any increase in his share of the total partnership liabilities shall be treated as though such partner had made a contribution of money to the partnership. Accordingly the effect of such transactions should be reflected in the analysis in the liability column for the partnership and in the "basis of partners' interests" columns.

(IV) As is pointed out in Regulations Section 1.704-1(1) (other than for the year end summary adjustments) it is unnecessary to make adjustments in this analysis except for transactions wherein partners' capital interests are affected in some manner. At the year end, however, adjustment to the basis of partners' interests should be made to take up any composite increase or decrease of total partnership liabilities, which entry automatically causes the basis of the partners' interests in total to agree with the total of partnership assets basis values (except as pointed out in the next rule).

(V) The general rule that the total of the basis of partners' interests will agree with the total of the basis values of partnership assets is subject to the exceptions where there is a change in the basis of partners' interests without a corresponding change in the basis values of partnership assets as a result of transactions set out in Code Section 734 and 743, when the optional adjustment to the basis of partnership property as provided in Section 754 has not been availed of. ☆

New partnership decisions this month

Trusts were bona fide partners despite capital donated by grantors. Taxpayers, husband and wife, were partners in a liquor rectifying business. They created four separate trusts for the benefit of their two children, and the trusts acquired partnership interests with the funds donated to them. Since the taxpayers had no right to control the use of the funds, the court finds the trusts were the true owners of the partnership interests. The share of the 1946 partnership income (some $90,000 after a $14,000 salary to the husband) to be taxed to the trusts, however, is the proportion which their capital accounts bear to the total capital of the business, including undrawn earnings which the taxpayers left in the business. This percentage is less than the stated percentage accruing to the trusts under the partnership agreement. [The court did not discuss the adequacy of the $14,000 salary. Since 1950, an interest in a family partnership created by gift is recognized, provided allowance is made for services rendered and the balance is divided in proportion to capital.—*Ed.*] *Broide*, DC Ill., 11/5/57.

Family partnership with trusts upheld (Old Law). Taxpayer and his wife had operated a wholesale china business for many years. In 1941, they liquidated their corporation and continued as partners. In 1944, they withdrew some $35,000 from the partnership, added $5,000 and created trusts for their two teen-age sons. The trustee invested the funds in the partnership. In 1945, the year in issue, the trust received profit equal to about 50% of its investment. The court holds that the partnership was valid under the test laid down in *Culbertson*—the parties had the requisite intention to engage in business as partners. [Under the present Code, partnership interests acquired by gift are recognized if the profit is properly allocated to partners performing services and equally in relation to capital invested.—*Ed.*] *Goldberg*, DC N. Y., 6/28/57.

1951 family partnership amendment doesn't affect pre-1951 partnership. This is a suit for refund of taxes for 1945-1948, paid when the Commissioner refused to recognize minor children as partners. In a previous suit involving 1944, a jury's decision against taxpayer had been affirmed. When this case was first presented, the lower court held that the decision on 1944 was *res judicata* for later years, but the Court of Appeals reversed and remanded on the ground, among others, that the 1951 liberalization of the IRC family-partnership rules should have been taken into consideration by the lower court. The lower court then held that the liberalization does not affect partnerships which came into existence before the effective date of the 1951 amendment. Accordingly, under the old rules, it held that for tax purposes the partnership is not bona fide, there being no real intent to join in business together. This court affirms. *Parker*, CA-9, 10/9/57.

NEW DEVELOPMENTS IN

Payroll taxes

EDITED BY PETER G. DIRR

California sets tax base for disability insurance

WE ARE reproducing in part below an article which recently appeared in the California Department of Employment News Letter. It is of particular interest to our readers who have California affiliations.

"For employers, one of the most significant enactments at the recent session of the Legislature was the establishment of a $3,600 tax base for disability insurance. The measure increasing the taxable wage limit for disability insurance contributions from $3,000 to $3,600 was part of a bill which also increased disability insurance benefits.

"Although the extension of the taxable wage limit for disability insurance will affect only employee contributions (calling for additional wage deductions up to the $3,600 figure for those who earn that much in the year), it also will require some changes in employers' payroll accounting.

"As the situation will stand January 1, 1958, the following changes in cutoffs will have to be taken into account for tax reports based on wages:

	Now	*Will be*
Federal Insurance Contributions Act (old age and survivors' insurance)	$4,200	$4,200
Federal Unemployment Tax Act (on employers of four or more)	3,000	3,000
California unemployment insurance (employer contributions)	3,000	3,000
California disability insurance (employee contributions)	3,000	3,600

Facts on OASI and disability insurance

A SMALL BROCHURE presenting some pertinent facts about OASI and the Federal Disability Insurance Trust Fund, gleaned from the most recent annual report to Congress by the Board of Trustees of the funds, has recently been made available by the U. S. Department of Health, Education and Welfare through the Superintendent of Documents in Washington.

The pamphlet discusses the nature of the trust funds involved, and offers information on the investment of the funds, their sources and benefits resulting from them. Available from the U. S. Government Printing Office for $3.00 per hundred. ☆

Treatment of Federal sick pay benefits for state income tax

WITH ALL the publicity given to the Federal "sick pay" exclusion, there will soon be many inquiries relative to the treatment of such benefits for state income tax purposes. Here is a chart which we have had prepared, giving the current status[1] in the various states as determined from a review of the law, regulations, rulings and departmental letters.

Deductible	
Same Amount As Federal	*Total Payments Under Employer's Plan*[a]
Alaska	Vermont
Hawaii[b]	Kansas
Iowa	Louisiana
Kentucky	New Mexico
Minnesota	North Dakota
Montana	Oklahoma[c]
New York	

Not Deductible	
Alabama	Georgia
Arizona	Idaho
Arkansas	Indiana
California	Maryland
Colorado	Massachusetts
Delaware	Mississippi
Dist. of Columbia	Missouri
North Carolina	Utah
Oregon	Virginia
South Carolina	Wisconsin

[1] Wage continuation payments under an employer's plan. In some states, new legislation is being considered in this area, while in others an exact position is not clearly manifested under the law or regulations. Undoubtedly there will be some changes made before tax return due dates.

[a] Without regard to $100 per week limitation.

[b] Effective 1/1/58. Prior thereto, total payments under employer's plan were excludable.

[c] Unless absence was due to an illness requiring hospitalization or to personal injury, the sick pay attributed to the first week of absence is not deductible.

Contribution rate binding unless appeal is timely

THE PENNSYLVANIA Supreme Court, in a decision handed down on November 11, 1957, affirmed a decision by the Pennsylvania Court of Common Pleas whereby it was held that an employer who was assigned an incorrect rate for the calendar years 1953 and 1954, and who failed within the 90-day limitation to file an application for review of his rate notices, was not entitled to a refund of his unemployment contributions overpaid. The amount involved was approximately $166,500.

This, then, should serve as a reminder to all employers that it is to their benefit to, immediately upon receipt of a contribution rate notice, verify the following items:

1. The amount of contributions credited to the employer's account
2. The amount and propriety of benefits charged to the employer's account
3. The mathematical calculation of the assigned contribution rate which is based usually on his reserve ratio, benefit ratio, or other method used.

In the instant case, Pennsylvania employers are allowed 90 days from the mailing date of the Notice of Contribution Rate in which to make an application for review of such notice in the event exception is taken to any of the items appearing thereon. The courts held that the contribution rate which was initially assigned was binding unless exception was taken in the manner, and within the time prescribed by the Pennsylvania statutes. ☆

Save on social security by issuing one check to couples

AN IMPORTANT cost in operating the social security program is the cost of writing and processing checks; it amounts to almost five cents a check. In 1956, the Bureau of Old Age and Survivors Insurance began issuing only one check instead of two to couples then being entered on the rolls. Now that practice is being extended to those who had been receiving checks previously. When all are shifted, the total saving is expected to amount to about a million dollars a year. Of course, those who wish to receive separate checks may request them.

NEW DEVELOPMENTS IN

Foreign aspects of taxation

EDITED BY SIDNEY I. ROBERTS, LL.B., CPA, JOHN COSTELLOE, LL.B., AND JOHN WILCOX, LL.B.

The foreign holding company – when should a company organize one?

by **ANDREW W. BRAINERD**

There are as many situations in which a foreign holding company is highly desirable as there are circumstances in which it is flatly impossible. Whether it is one or the other, or somewhere in between, will depend largely upon the answers, in a specific factual situation, to certain specific questions. Mr. Brainerd, a Chicago, Ill., lawyer, poses these questions for us and indicates the answers in typical situations. This article is an adaptation by the editors, with Mr. Brainerd's consent, of a talk he delivered before the International Management Association Conference held in New York recently.

As in so many fields, the absence of a common understanding of terms has contributed very greatly to confused thought. Essentially, a *pure* foreign holding company is simply any foreign subsidiary corporation which *holds* or owns securities of other corporations, income-producing rights (such as patents), or other property, real or personal.

There is no reason why the foreign holding company cannot—and, in fact, our law unequivocally and strongly recommends that it should—engage in regular business activity totally apart from its "holding" function. Frequently this will mean manufacturing or selling operations within one or more foreign countries. It might be said to be increasingly common that such a company acts as a trading company—purchasing, from some foreign point, goods of its U. S. parent for sale to some other foreign destination. To simplify both the concept of the foreign holding company and the considerations which control its use, we shall assume hereafter that the entity analyzed is *pure*, in that it merely owns: (a) shares of stock in certain foreign sub-subsidiaries, and (b) the rights to foreign patents.

An able executive, thoroughly informed in this broad field, Mr. E. R. Luter, manager of foreign taxes and finance for Sears, Roebuck and Co., recently observed: "It is probably advisable, both from an organizational and a tax standpoint, for any company of size which contemplates a long-range plan of foreign expansion to form and use a foreign holding company." The manager of income taxes of the U. S. Gypsum Company, Victor C. White, reflects wide and successful experience in this connection when he says: "If money is to be earned abroad, the foreign holding company has the essential advantage of deferment of U. S. tax, which in all probability would not be available if no foreign holding company is used."

Let us go at once to the heart of the advantage these men refer to, and summarize it in this way: Any foreign subsidiary's earnings which are paid in dividends directly to its immediate U. S. parent, are subject at once upon receipt here to the full U. S. tax of 52%—only the residue of 48 cents out of each dollar of foreign earnings can be then redeployed abroad in expanding operations. If, on the other hand, the active foreign subsidiaries pay their dividends out of the country where they were earned, to an intermediate foreign holding company, those earnings will be received by the holding company without additional tax, and the full amount of the dividend (100 cents on the dividend dollar) can be immediately redeployed abroad. The principle is remarkably simple.

The saving changes appreciably (though the principle always remains the same) when we get into the adjustments which our law permits for foreign income taxes paid, a factor of major concern in determining the immediate usefulness of a foreign holding company. But before we weigh the *degrees* of advantage which this vehicle may offer, let us first decide whether or not the "foreign personal holding company" sections of our tax law totally forbid its use, under the circumstances of a given case.

If any five or fewer families own more than 50% of the voting shares in a corporation which is a *pure* holding company, this vehicle is not for them, because our law will immediately tax these shareholders on all sums received in dividends or royalties by their closely held foreign holding company. The small number of shareholders, and the passive nature of the income, combine to convert the foreign holding company into a foreign *personal* holding company. One has tax advantages; the other tax disadvantages.

Now there are means of averting the tax penalty imposed by these sections of the Code. They are, for the most part, concerned with engaging in the active conduct of a business in conjunction with the *holding* of property, to such an extent that the amount of passive income will be more than balanced by active income—in which event, of course, the foreign company loses its role as a *pure* holding company. We shall not discuss the refinements of these sections, but we can conclude our first inquiry in this way: Widely owned corporations are not prevented by these sections from operating *pure* foreign holding companies, but closely held corporations are. Those companies in the first category may shortly pass to a consideration of *to what extent* they stand to benefit from such an entity. Those in

[1] See, for example, 34 *TAXES—The Tax Magazine*, 231, at 242-4.
[2] An exposition of this subject, and the taxable incidents of trade touching various countries, will be found in an article entitled "Foreign Trade and Foreign Corporations Under Internal Revenue Law," which appeared in the December 24 and December 31 issues of *Export Trade and Shipper*.
[3] 34 *TAXES—The Tax Magazine*, 231, at 238-9.
[4] *Export Trade and Shipper*, Vol. LXXIV, No. 22.
[5] 34 *TAXES—The Tax Magazine*, 231, at 255.

the latter group must first consider how they can best utilize a foreign subsidiary, existing or to be formed, as an instrument which will do an active, continuing business abroad and which will at the same time lawfully *hold* shares in other foreign subsidiaries. You will recall that it is quite proper, and in fact absolutely desirable, that these functions be combined in any event, even by widely held companies. The term "pure holding company," of course, is used as an example so that we may have a common reference concept, rather than an ideal prototype to pursue.

The existing foreign structure

Where no foreign subsidiary already exists, there is no legal impediment which hinders the creation of a foreign holding company in direct conjunction with the formation of its subsidiary. It has, however, for some time been regarded as law that a U. S. company owning an existing foreign subsidiary might not simply transfer tax-free its shares to a foreign holding company (in exchange for shares of the latter).[1] Such an "exchange" of shares, it was said, must result in a capital gains tax being assessed against the U. S. parent on the excess of the *fair* value of such subsidiary over its *book* value. Exceptions to the rule were conceded in those instances where the foreign operating subsidiary had just been formed, where it had made no profit or sustained a continuing loss, possibly where it had an accumulated deficit, or where major economic factors arose unexpectedly to affect its posture.

But it is perhaps not inappropriate to say here that recent statements have been made publicly, by responsible Treasury officials and by certain influential members of Congress, to the effect that where foreign earnings are unquestionably to be elsewhere used directly in foreign expansion, it is not inconsistent with our governmental policy that such transfer of earnings be allowed without tax consequence here. There is, of course, no means of effecting this transfer of earnings in many situations, other than through the use of a foreign holding company. I would say, therefore, that it is no longer a matter of certainty that the only subsidiaries which may be transferred today without tax cost are those listed previously here as exceptions. What has been Treasury policy no longer squares with the understanding and wishes of our legislature; neither can it be reconciled with the objectives of the Administration, re-expressed often and in varying form.

In anticipation of what may well be a changing Treasury attitude, there are several less direct means of making transfers of existing shares—other than by "exchange," which might profitably be explored—assuming a transfer of shares to a foreign holding company to be desirable in a given case. For example, in some situations the sale by a U. S. parent to its foreign holding company of a profitable foreign subsidiary may give rise to capital gains income today as opposed to ordinary income, taxable at twice the rate, tomorrow.

To conclude this section, we may say that new subsidiaries may be placed without difficulty under a foreign holding company. Old subsidiaries may, or may not, also be transferred, depending upon the results of a careful study of the individual circumstances.

The foreign tax credit

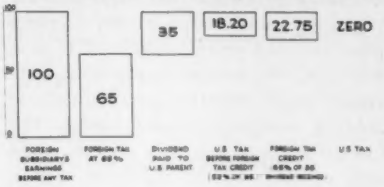
Our law allows a credit, or offset, against the U. S. tax on foreign income of a domestic company, roughly equal to the amount of taxes paid to some foreign country on that income. It is of course possible for the same income to be taxable in various jurisdictions at the same time.[2] Consequently, the provision allowing a credit could not have been avoided as our foreign commerce grew, because—if no credit were allowed and a deduction alone were permitted (as had theretofore been the case)—any foreign income might very soon be wholly depleted.

The *credit against the U. S. tax* will probably always be far more beneficial to the U. S. taxpayer, than *deduction from taxable income*. Some years after the passage in 1918 of the original "foreign tax credit" sections, the privilege of crediting (against the U. S. tax), rather than deducting (from taxable income) the foreign taxes paid, was extended to cover not only domestic corporations but foreign subsidiaries as well. For a number of years, then, the foreign subsidiary has been entitled to pay dividends into a U. S. parent and have the U. S. tax on such dividends (52% of the dividend), reduced by foreign taxes paid abroad with respect to such dividends.

Now all of this has an important bearing upon the foreign holding company question, and for one very basic reason: If the foreign taxes paid were assessed abroad *at an effective rate equal to, or in excess of, the U. S. rate of 52%*, it would serve no useful purpose to pay dividends out of a foreign country and into a foreign holding company, simply because we may actually pay the same dividends into the U. S. parent *without any further tax cost in the United States.* The foreign tax credit provisions enable us to do just that, as is indicated in Exhibit I, wherein we assume a very high rate of tax, for example, such as exists in Japan of 65%. Under these circumstances, the primary function of the foreign holding company has disappeared: i.e., deferral of U. S. tax. Where—after adjusting for foreign taxes paid—no tax is due here, obviously no deferral can be effected.

EXHIBIT I

AS FOREIGN TAX RATES RISE, THE ADVANTAGE OF THE FOREIGN HOLDING COMPANY DIMINISHES



The maximum advantage of the foreign holding company can be realized only if our foreign income is subject to tax in countries in which rates of tax are relatively low. We might generalize with reasonable accuracy that a foreign holding company *should* be formed if it is to hold shares in operating subsidiaries in low-tax countries (such as exist throughout Latin America, for example); that it is of lesser value if used to own subsidiaries in high-tax countries (such as some continental and Far Eastern countries, for example).

It might be said here, in fairness, that —although of limited practical application—there are several additional advantages of a technical nature (described elsewhere in some detail)[3] which favor the use of the foreign holding company even in high-tax situations. For example, a U. S. parent having a foreign holding company may well be enabled to utilize the excess foreign tax credit derived from a high-tax country's dividends, which otherwise would be lost. In Exhibit I this amount is $4.55 ($22.75 − $18.20). Again, passing earnings on a current basis from a medium-tax country through a foreign holding company may—depending upon the combined

rates of taxes paid—result in tax savings of up to 22% of the tax.[4]

In taking leave of the foreign tax credit considerations, we must make one last and highly important inquiry: What percentage ownership do we contemplate in the foreign subsidiary? If it is less than 50%, we may be effectively prevented from utilizing an intermediate holding company because, unless the foreign holding company directly owns 50% or more of the shares of such a sub-subsidiary, no credit whatsoever is allowed here for foreign taxes paid by the latter. Therefore, if relatively small minority interests are being sought, it is doubtful, although not inconceivable, that we would wish to surrender this valuable credit. In the minority equity situations, the foreign subsidiary shares will no doubt best be owned directly by the U. S. parent. An exception to this rule might exist where it was contemplated that ordinary dividends, as such, not be paid by the foreign holding company to its U. S. parent; the foreign tax credit would then be lost in any event, as it is only available when dividends (not including liquidating dividends) are paid. Capital gains treatment of the liquidation profit would then be sought.

The impact of tax treaties

There exist today, among most of the major trading nations of the world, approximately 160 tax treaties, some, but not all, of which provide for the application of special tax rates in transactions touching these treaty countries. Contrary to general understanding, these treaties have been negotiated for the financial advantage of the taxing governments themselves, rather than to help their taxpayers. This financial benefit is obtained by limiting the taxation of one treaty country—where income of specified types is earned there and paid out to a party within the other treaty country—thus allowing the second treaty country to tax more than it would have, had there been no treaty.

Let us take a specific example. By law, Canada applies a 15% withholding tax to all dividends paid to foreign (as well as to Canadian) shareholders. A U. S. company, doing business here, is clearly *foreign* to Canada. Therefore, if a dividend were paid by a Canadian subsidiary to its U. S. parent, that dividend should be subject to a 15% withholding in Canada. *However*, the United States has a tax treaty with Canada which, as recently modified, says that if 51% or more of the shares of a Canadian corporation are owned directly by a U. S. company, the rate of withholding in Canada shall be reduced from 15 to 5%.

Now let us assume for a moment that we had placed all the shares of a Canadian subsidiary into a foreign holding company, formed, let us say, in Venezuela. Venezuela has no tax treaty with Canada, nor with any other country. Dividends paid, therefore, from the Canadian subsidiary to a Venezuelan company shareholder do not receive the preferential rate of withholding accorded to the same payment if made directly to a U. S. company. The additional Canadian tax incurred by paying a dividend to a Venezuelan holding company rather than directly to the U. S. parent, is 10%. Such a penalty would recommend strongly against the use of a foreign holding company under the circumstances—or more accurately, against the use of such a holding company formed in Venezuela.

From this example, we may generalize accurately that tax treaties constitute a powerful factor in deciding upon: (a) the use of a foreign holding company in any given situation; and (b) if one is to be formed, what country should be selected in which to form it. We know that the United States has tax treaties with Australia, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Honduras, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Sweden, Switzerland, Union of South Africa, and the United Kingdom. If the ownership of shares in a subsidiary in any of these foreign countries, therefore, is placed in a non-U. S. (foreign holding) company, we know that payments made to such foreign holding company will not necessarily be taxed abroad in the same manner as would such payments be taxed if made directly by the subsidiary to the U. S. parent. Of course, the provisions of the many tax treaties of the world differ considerably. Some countries, naturally, are more favored than others, and I would by no means say that the provisions of the U. S. treaties yield the greatest advantages.

In the knowledge that the tax treaties of the United States do not, in fact, stand out as particularly beneficial, it will become apparent upon sufficient reflection that it should be possible to form a foreign holding company in a country which enjoys attractive tax treaty relationships with other countries, which U. S. companies—because they are limited to the benefits (if any) of the U. S. treaties—cannot enjoy. In this way, not only would the U. S. tax be deferred, but in fact there would be a *lesser* tax applicable in the country from which the dividend is paid to the treaty country's foreign holding company. Such a situation could be illustrated by a Swiss holding company receiving dividends from a French operating subsidiary; there is no withholding tax in France on such dividend payment, by virtue of the tax treaty between Switzerland and France. Were those same dividends paid directly to a U. S. parent, the French withholding tax would be an additional 19.8%. (The United States-France treaty does not provide for a lowered French withholding on dividends.)

We may conclude properly from these examples that tax treaties often vary local tax rates on certain types of income, particularly dividends and royalties; that in some situations we may lose an advantage from a U. S. treaty through the employment of a foreign holding company; that by the judicious selection of a country of foreign incorporation for the foreign holding company, it may in certain situations derive foreign tax (as well as domestic tax) advantage not otherwise available to the United States parent.

Where are foreign companies formed?

Basically speaking, our tax law recognizes only two kinds of corporations—the foreign and the domestic. And the concern which is often shown for the prospective domicile of the foreign holding company seems to be based very often not upon the main inquiry, but on collateral matters.

If the tax laws of a foreign jurisdiction do not tax foreign-source income, it is initially suitable for purposes of this type of incorporation. Next, if it is also one in which substantial business is actually under way or immediately contemplated, it may well be prudent to make use of its laws. I believe that exchange problems are far more important in this overall decision than most people would concede—on this extremely complicated and constantly altering subject there is virtually nothing written, and but few are informed more than casually. We have already noted the importance of tax treaties, if any be present, in the selection of a foreign country of incorporation. This issue follows closely upon a considera-

tion of the political and other legal considerations (expropriation history, for example) which characterize a country.

Among some 35 countries which are available for the purpose of incorporating foreign holding companies,[5] those persons interested are normally reduced to a single selection. Canada—because of its stability and language, its tax treaties, its economy, and the clarity of its law—offers distinct advantages difficult to duplicate. On the basis of history, Panama is the most widely used, the least expensive both now and later, and probably the least complicated of all. It, too, has a stable and friendly government which, as influenced by the presence of the Canal, will in all probability remain so disposed. Switzerland, for its tax treaties, is certainly outstanding; Liberia and Liechtenstein meet very well, and simply, the requisite that income foreign to the country of incorporation not be taxed there. For a brief period, recently ended, there was a flurry of incorporations in the country of Venezuela. Except in those instances where actual operations were conducted there, these would appear to have been ill-conceived in view of that government's extension of its gross receipts tax to income of Venezuela companies from all sources, worldwide. Some of these companies have already been dissolved in the light of this highly adverse development. ☆

Taxes in the United Kingdom

THE TAX situation in the United Kingdom is discussed in the third number of "Taxes Abroad," an excellent series of pamphlets being issued by the Canadian Tax Foundation. This interesting number, dated October, 1957, covers the income and profits taxes in the U. K., and also the foreign tax credit and international aspects of bilateral tax relief. Copies are available from the foundation, 154 University Avenue, Toronto 1.

New foreign decisions this month

Foreign tax credit limiting ratio to reflect untaxed foreign investment income. Section 131 limits the credit for foreign taxes to an amount not in excess of the proportion of the U. S. tax which the taxpayer's normal tax net income from sources within a foreign country bears to his entire normal tax net income. Taxpayer here is a mutual insurance company which paid Canadian income tax on its underwriting profits only. However, it stipulated with the Commissioner that the denominator of the limitation fraction should consist of its entire net investment income from the U. S. and Canada. The court holds that because of the stipulation of the denominator, it must include in the numerator Canadian investment income even though Canada did not tax such income. *Federated Mutual Implement & Hdwe Ins. Co.*, 29 TC No. 30.

Western Hemisphere affiliate may engage in intercompany transactions with parent. Intercompany sales between a U. S. company and its domestic affiliate doing business in Venezuela will not adversely affect the qualifications of the affiliate as a Western Hemisphere trader. Sales to the U. S. parent will not affect the three tests for W-H corporations: business all done in this hemisphere; 95% of income from sources outside the U. S. (title in these sales passed abroad); and active conduct of a business. However, the IRS adds, transactions between all related companies are subject to special scrutiny and if they are not at arm's length, income will be reallocated. *Rev. Rul.* 57-542.

Nonresident alien selling stock can get refund of withholding if dividend goes to buyer. Under stock exchange rules, the seller of stock prior to the ex-dividend date must turn it over to the buyer. If the seller is a nonresident alien, tax will have been withheld by the paying company. Refund of the withheld tax will be made to the seller. *Rev. Rul.* 57-567.

Tax Convention talks to be held with Peru. Technical discussions are to begin soon looking toward a tax convention with Peru. Suggestions for scope and content may be submitted to Dan Throop Smith, Deputy to the Secretary of the Treasury. *Notice* IRB 1957-32.

Cuban Telephone income is from outside the U. S. Interest and dividends are not from U. S. sources if less than 20% of the corporate income for three years prior to the year of payment is not from U. S. sources. The IRS rules that Cuban Telephone Company interest and dividends for 1957 are, under this rule, not from U. S. sources. [Nonresident aliens are therefore not subject to U. S. tax on them nor is withholding required.—*Ed.*] *Spec. Rul.* 4/11/57. Similarly for Porto Rico Telephone Co., *Spec. Rul.* 4/18/57.

OTHER DECISIONS

Investment company doesn't have gain or loss on dividend distribution of portfolio stock. A dividend distribution by a regulated investment company to its shareholders of portfolio securities results in no gain or loss to the company. The deduction for dividends paid equals the adjusted basis for the securities. The IRS points out that the stockholders treat the distribution as a dividend under the general rules [the value of the distribution is income to the extent of the accumulated earnings of the corporation.—*Ed.*] and that the amount which can be reported as a capital gain dividend is limited to the corporation's realized capital gains. [Distributions of capital gains by regulated investment companies are capital gain to stockholders.—*Ed.*] *Rev. Rul.* 57-421.

Banks may use bad debt experience for any 20 years after 1927. A bank computing additions to a reserve for bad debts under the alternative method may select any 20 consecutive years after 1927 as its base whether or not it was in existence during the entire period. For that portion of the 20-year period it was in existence, it must use its own experience; for that portion of the period it was not in existence, it must use the debt experience of other similar banks. *Rev. Rul.* 57-350.

Farm co-op's deferred patronage certificates had no market value; not income on receipt. Noting that the Commissioner is persisting in his attempts to tax revolving fund certificates regardless of their market value, the court adheres to its position that they are not income to cash basis taxpayers if they have no market value. The certificates had, the court finds, no market value. They bore no interest, had no fixed maturity date, were subordinate to all other obligations of the cooperative and two local bankers testified they were not saleable and had no value as loan collateral. *Miller*, TCM 1957-98.

NEW DEVELOPMENTS IN

Fraud & negligence

EDITED BY HARRY GRAHAM BALTER, LL.B.

Concept of what constitutes tax fraud enlarged

A LONG-RANGE development in tax fraud investigations which is worth noting is the gradual enlargement of the concept of what constitutes a tax fraud, in the opinion of Spurgeon Avakian, partner in the Oakland, California, law firm of Avakian & Johnston.

At the Tenth Annual Federal Tax Conference of the University of Chicago Law School, he said: "We think of fraud in a general sense as a deliberate misrepresentation of a material fact for the purpose of obtaining an advantage.

"Intent is subjective and, therefore, hard to measure or evaluate. It must usually be determined by reference to circumstantial evidence, and the pertinent circumstances may support conflicting inferences, depending on how the various bits of evidence are related to each other and the amount of emphasis which is given to each of them.

"What, for example, of a taxpayer who knows that his records are inadequate and yet does nothing about it? At the end of the year, he prepares a tax return which he knows must be inaccurate, but which represents the best that can be done under the circumstances. Even though the estimates and assumptions which his return reflects were made in good faith, is he guilty of fraud if it later develops that he materially understated his true tax liability? Or suppose that a taxpayer delivers a batch of miscellaneous records to an accountant and instructs him to prepare the best return that he can for a fee which will not exceed $100. If the accountant tells him that the preparation of an accurate return would involve a much greater fee and the taxpayer, nevertheless, holds to the limit of $100, is he guilty of fraud if it later develops that the return prepared in this manner was substantially inaccurate?

"A jury's evaluation of the question of intent reflects in part the general public's view of an honest taxpayer. As the public becomes more conditioned to the necessity of adequate records for the correct determination of income, it will raise its standards as to what a taxpayer should do. Thus, while the taxpayer in the two examples mentioned above would undoubtedly be considered free of criminal intent at the present time, it is conceivable that in future years the deliberate failure to keep adequate records will be viewed as criminal tax-evasion conduct.

"It is clear that those who administer the tax laws tend constantly to expand the boundaries of the type of conduct which is considered fraudulent. The common inquiry of Special Agents as to whether the taxpayer circumscribed the amount of work which the accountant should do indicates a trend in their thinking that the absence of adequate records may be an indication of a fraudulent mind. Adjustments which a few years ago were considered purely technical are now often made the basis of fraud charges." ☆

American Law Institute offers guide to tax fraud cases

A SIMPLE and handy guide to our system of investigation and detection of a criminal violation of the Federal income tax laws is offered in a new book, "Criminal Aspects of Tax Fraud Cases," by Boris Kostelanetz and Louis Bender, published recently by the Committee on Continuing Legal Education of the American Law Institute, collaborating with the American Bar Association.

The book, one of a series on taxation for the general practitioner, follows the criminal tax case through each stage of formation, development and trial, and analyzes each element to give the practitioner an understanding of the problems involved. In addition to outlining the statutes and judicial decisions applicable to the issue as a whole, practical problems are discussed wherever possible.

Criminal Aspects of Tax Fraud Cases, by Boris Kostelanetz and Louis Bender, published by the American Law Institute, 133 South 36th Street, Philadelphia, Penna., August, 1957, $3.00 per copy. ☆

New fraud and negligence decisions

Reconstructing income by bank deposit method improper; deposits came from prior savings. Taxpayer's only source of income during the taxable years was from a watch business for which he kept adequate books and records reflecting all transactions. The Commissioner's reconstruction of taxpayer's income by use of bank deposits is held to be improper particularly since taxpayer offered proof that the "unexplained" deposits were made from funds brought with him when he emigrated to the U. S. in 1933. The fraud penalties are rejected. *Damski,* 29 TC No. 1.

Fraud penalties assessed against "betting commissioner." Taxpayer was engaged as a "betting commissioner" in violation of both state and local law. Because he failed to maintain any permanent records reflecting his gambling operations, the Commissioner's use of the bank deposit method to reconstruct his income is held not to be arbitrary or invalid. In determining the unreported income, the court allows taxpayer personal gambling losses only to the extent of gambling gains. It also sustains the fraud penalties after a finding that the understatements of income were due to a fraudulent intent to evade taxes. *Cohen,* TCM 1957-172.

Deficiency based on net worth increase. The Commissioner determined deficiencies against taxpayer on the basis of unexplained increases in his net worth. Based on the record, the court reduces the determination by a conceded wedding gift of $1,000 and by an amount representing an overstatement of taxpayer's living expenses. Fraud penalties were not sustained. (The court noted that the Commissioner completely ignored this issue in his pleadings, proof and brief.) Penalties for failure to file declarations of estimated tax and for substantial underestimation were upheld. *Hollander,* TCM 1957-138.

Special Agent's description of examination as "routine" not misleading [*Certiorari denied*]. Taxpayer had been convicted of tax evasion. On appeal he argued that he was led to believe that a routine audit was to be made and if he had known there was a Special Agent assigned to his case he would not have given up his papers without advice of counsel. The Third Circuit quoted instructions given revenue agents examining "racket groups" to inform taxpayers that a routine examination was being made. "Be cautious and alert and cultivate the confidence of the taxpayer without tipping your hand as he may cooperate to some degree with you . . ." While deploring the tone of this instruction, the court said that describing the examination as routine meant merely investigating to determine routine civil liability. The jury was properly instructed to disregard evidence obtained by fraud, force, persuasion, misrepresentation, trickery or deceit of the Government agents. The circuit court upheld the jury's finding of guilty on these instructions, commenting that every examination is, in a sense, routine at the start, and that taxpayers do not consider an audit by a revenue agent to be a call for purely social purposes. The court further held that the evidence as to the opening net worth was sufficient for the jury to infer that defendant did not have the cash hoard he claimed. *Frank, cert. den.* 10/14/57.

Substantial unexplained understatements of income fraudulent. Taxpayer operated an army and navy store as a sole proprietor and also conducted a licensed pawn shop in one corner of the store. In addition, taxpayer maintained an active brokerage account, held rental properties, and from time to time traded in diamonds. His records were both incomplete and inadequate to reflect the taxable income. The court permits a reconstruction of taxpayer's income under the net worth method after allowing for certain adjustments. It also finds that a substantial under-reporting of large amounts of income represented a consistent pattern for a number of years, and sustains the fraud penalty. *Lewis,* TCM 1957-158.

Hotel operator's income reconstructed by net worth. A hotel operator omitted substantial rent checks from income; took duplicate deductions, and reported on his returns an excess of deductions over the amounts recorded on the books. He also made bank deposits in several years in excess of the cash which appeared available therefore on the books. Use of the net worth method to determine the correct income is held justified. The court also sustains fraud penalties for the years 1943-1946. For 1942, in which year the Commissioner failed to prove fraud, the forgiveness feature of the Current Tax Payment Act of 1943 is held to be fully available to taxpayer. *Mills,* TCM 1957-157.

Diversion of corporate income to sole stockholder fraudulent. The sole stockholder of a corporation diverted corporate income by endorsing and cashing certain corporate checks and using the proceeds personally. The court holds the stockholder liable for the corporate tax as transferee to the extent of the appropriated checks, and finds both the corporate and individual stockholders' returns fraudulent with intent to evade tax. *Meyer,* TCM 1957-166.

Cattle feeding operations reconstructed by net worth. Taxpayer was in the cattle feeding business. He purchased grass-fed cattle normally two or three years old which he brought to his feed lots where they were fed until they reached marketable weights and then sold as beef cattle. Use of the net worth computation, with certain adjustments, is upheld in reconstructing taxpayer's income for 1944-1947, since he failed to keep any books on his operations. A net operating loss carryback to 1946 from 1948 is allowed; however, the loss does not include $12,000 state income tax, a nonbusiness expense. The court also sustains the fraud penalty because of gross understatements of income without adequate explanation, and the alterations on checks issued in payment for real estate to read in payment for operating expenses. *Schroeder,* TCM 1957-162.

Tax Court unrealistic in setting opening net worth at zero working capital. Taxpayer's records of his wholesale fruit and vegetable business were, the Tax Court found, inadequate and improperly kept. It therefore upheld the use of the net worth method and in addition found that the understatements were due to fraud. This court agrees that the net worth method is proper but finds the computation of assets at the beginning unrealistic. Taxpayer must have had considerable cash and receivables on hand. The Tax Court was not warranted, the court says, in disregarding taxpayer's large cash purchases, his growing business and testimony about the use of cash. However, the Tax Court is sustained in its finding that taxpayer's "partnership" with his wife was a mere assignment of income. The case is remanded for further hearings. *Gunn,* CA-8, 8/8/57.

Bank deposits used to determine income of betting broker. Taxpayer, betting broker or go-between who took bets from various bettors, kept no books or system for keeping records of his income. The court, affirming the Tax Court, upholds use of the bank-deposit method to determine his income and allows the taxpayer, by application of the *Cohan* rule, 75% of the total deposits and undeposited checks as transfers and other nontaxable items. *Rogers,* CA-7, 10/21/57.

Bank deposit method used to reconstruct income of black marketeer. A lamp manufacturer kept a false set of books during 1944-1947 for the primary purpose of hiding his black market operations. The Commissioner reconstructed his income by the bank deposit method. The court accepts the method of computation but allows for a downward adjustment of the unreported income because of redeposited items and loans. Fraud penalties are upheld. *Cantor,* TCM 1957-173.

Can't suppress information disclosed by accountant; he was taxpayer's agent [*Certiorari denied*]. Taxpayer, a county clerk, also conducted an insurance business and prepared tax returns for others. When a Special Agent began to examine the returns he prepared, as well as his own returns, taxpayer engaged a lawyer (who soon dropped out) and a public accountant. In the course of many interviews, the accountant disclosed much information about taxpayer's affairs. This information the district court refused to surpress and the Second Circuit agreed. There was no affirmative act of deception by the revenue agent or the Special Agent. Taxpayer knew that he was under examination, the disclosure was voluntary, and the accountant was taxpayer's agent and his disclosure was within the scope of his authority. That the accountant was not enrolled to practice before the Treasury is irrelevant. *Russo, cert. den.* 10/14/57.

NEW DEVELOPMENTS IN
Tax policy & legislation
FOR PRACTITIONERS

AICPA urged to take active role in studying, recommending, tax policy

THE AMERICAN INSTITUTE of Certified Public Accountants is currently considering abandoning its policy of limiting its tax recommendations to technical matters on which it has unusual competence. For years it has resisted the efforts of those who would have it speak on matters of equity and policy. Now John P. Goedert, a partner of Alexander Grant & Co., Chicago, and a tax specialist long active in Institute affairs has attacked this problem publicly. In a speech at the AICPA annual meeting in New Orleans he argued eloquently for assumption of what he called "civic, moral and professional responsibility."

The Institute Federal tax committee has won much praise for itself and the Institute as a whole in recent years by its diligent study of the technical aspects of taxation. The very fact that it has confined itself to technical matters is argued by some to be one reason its recommendations have been so well received in Washington, by the bar, and by taxpayers in general. If the Institute, so this argument runs, were to take positions on policy, such as percentage depletion, special educational exemptions, exemptions for working mothers, etc., etc., it would loose some of its effectiveness in the purely technical area. Those who disagreed would, presumably have less respect for AICPA recommendations in general. On technical matters its knowledge and right to speak are unquestioned. On broad policy matters, the argument runs, the Institute is just another group of taxpayers, perhaps, but perhaps not, more knowledgeable, more fair-minded, wiser, than other similar groups with different views.

Mr. Goedert's views

Mr. Goedert concluded his comments on inequities in our present tax system with a plea for the Institute to become active in recommending tax policy, in these words:

Overall study a comprehensive task

"To attempt to study all of those provisions which involve special tax benefits; to attempt to analyze the relative economic, political and social justifications for various special provisions; to determine those provisions which should be abandoned and those which should be continued—this involves a task tremendous in its scope, exceedingly demanding of those responsible for it—a task which, at best, is thankless when you consider the impossibility of satisfying all of the diverse interests that would be affected.

Congressional studies

"Various aspects of the Internal Revenue Code have already been studied by Congressional groups. Suggestions have been made that a Congressional group should undertake a comprehensive and overall study of the entire Code with the objective of removing inequities.

"Several years ago, during the 84th Congress, extensive hearings were conducted before the Subcommittee on Tax Policy of the Joint Committee on the Economic Report. Outstanding men in the fields of economics, industry and taxation submitted documentary studies and testified in the course of the hearings. The resulting report of the subcommittee included the following comment: "The inequities in the present tax system are to be found primarily in those provisions of the tax law which afford some taxpayers preferential treatment as compared with others in fact similarly situated, and which serve to reduce, very markedly, progression in tax burdens. Both the need for greater built-in flexibility and for balanced economic resources suggest a tax policy which would greatly reduce these inequities."

This would imply that Congress is well aware of the problem.

"However, to anyone with the slightest conception of legislative processes, it is unrealistic and completely unfair to assume that an elected group of Congressmen with an eye towards the political significance of their actions and with an ear towards the demands of their constituents, will ever be able to study the Code objectively for the purpose of minimizing the inequities that presently exist. It is, for example, just as conceivable that the Senator from Delaware will approve the delegation of clam shells from those items entitled to depletion as it is to assume that the Senator from Texas will approve the elimination of percentage depletion applicable to oil extraction.

"In brief, I sympathize with the position of our political representatives. I think it is not only unrealistic but unfair to expect them to be completely objective in their attitude towards the benefits enjoyed by their constituents. I don't think the Congress should be expected to undertake the task of reviewing the equities and inequities of our present Code.

"A little reflection will lead many of us to the conclusion that to be really effective, such a review and revision of our tax statute must be conducted by a completely independent, nonpolitical commission. Such a commission would be composed basically of outstanding individuals engaged in the field of taxation as accountants, attorneys or educators.

"The members of the commission should have no restrictions imposed upon their functioning and should not be confronted with arbitrary time schedules. The sole objective of such a commission should be to develop a specific outline of an equitable and fair tax statute that will produce the required revenue with a minimum of inequity and a maximum of fairness to all taxpayers. The AICPA has already gone on record as advocating the appointment of such a commission.

Is our duty discharged?

"Perhaps some of you might very well feel that we have served our function and discharged any duty that we might have by reaching such a conclusion and by making such a recommendation. Now we can just sit back and wait for the functioning of this independent commis-

Announcing the first major break-through in vital tax research – the

TAX PRACTITIONERS' LIBRARY

Designed to free you of burdensome spade work – add authority to your handling of important problems – give you new productive hours each day!

***Edited by* ROBERT S. HOLZMAN**
—Top Federal Tax Authority

The Tax Practitioners' Library incorporates in each volume the practical organization and approach conceived by Editor Robert S. Holzman. To the Library he brings twenty years' experience as tax administrator for a major corporate group and a prolific writing background on tax subjects. Professor of Taxation at New York University, Dr. Holzman is Past President of the Federal Tax Forum, Inc., and a member of the Tax Institute and the Controllers Institute of America.

HERE, for the first time, is a practical way that everyone with major tax interests can be "armed to the hilt" with knowledge of tax law and interpretation *where it most counts,* without days and weeks of exhaustive research. Recognizing that most tax "failures" result from an imperfect grasp of the Internal Revenue Code's meaning as actually hammered out in complex and lengthy litigation, renowned tax authority Robert S. Holzman has organized this powerful new reference tool aimed at the key areas where tremendous savings are won or lost today.

Ready Now!

ARM'S LENGTH TRANSACTIONS

Robert S. Holzman. This is the definitive guide to answering the question: *what is an arm's length transaction?* Shows how to recognize, avoid transactions executed at less than arm's length—indicates the circumstances under which the Treasury may reallocate items of income and expense. Sets forth taxpayers' arguments, together with the courts' reaction to each case. Cases are classified by industries. *160 pp. 6 x 9.*

Ready Now!

THIN CAPITALIZATION

Martin M. Lore, CPA; N.Y., Dist. of Columbia Bars. Authoritatively analyzes the problem of the thin corporation — how to avoid tax traps without giving up the benefits. Considers validity of capitalization and recapitalization, interest deduction, bad debt treatment, recognition of gain or loss on transfer, etc. Leading cases analyzed to show amount and ratio of debt to stock, valuation of underlying assets, business purpose, and intent. *240 pp. 6 x 9.*

Ready Now!

THE TAX ON ACCUMULATED EARNINGS

Robert S. Holzman. The first book to fully examine the nature of this tax: who is vulnerable, when, and why. Every argument ever raised in court to justify retention of earnings is analyzed to show the effect of judicial examination. Decided cases arranged by industry to indicate the extent to which peculiar problems of the industry have been accepted as extenuating circumstances. Specific tax-avoidance suggestions. *140 pp. 6 x 9.*

THE TAX PRACTITIONERS' LIBRARY
...coordinated reference volumes

ARM'S LENGTH TRANSACTIONS—Holzman
THIN CAPITALIZATION—Lore
TAX ON ACCUMULATED EARNINGS —Holzman
ORDINARY AND NECESSARY EXPENSES —Carson-Weiner
REPAIRS VS. CAPITAL EXPENDITURES —Gordon-Wriggins
EVASION VS. AVOIDANCE—Gutkin
SOUND BUSINESS PURPOSE —Holzman
UNREASONABLE COMPENSATION—Peloubet-Halsey
TRAVEL AND ENTERTAINMENT EXPENSES—Schorr
ASSIGNMENT OF INCOME—Summa
ESSENTIALLY EQUIVALENT TO A DIVIDEND —Seghers

...each by a recognized authority

Facts—Arguments—Decisions —In Unique, Capsulized Form!

Each volume in the Tax Practitioners' Library covers a critical problem raised by the Code. Each presents a comprehensive review of the courts' interpretation of the law and the results of research of taxpayers' experience in litigation. Each arranges the facts, arguments, precedents, and decisions of all significant court cases in quick-reference capsulized form—classified according to relevant concepts.

Basic equipment for corporate officers as well as accountants, lawyers, and tax consultants, the Library brings into immediate focus the essential information for avoiding dangerous financial and personal liabilities—and for planning sound defense of any challenged situation.

Special Subscription Offer — Clip and Mail Coupon Today!

THE RONALD PRESS COMPANY, 15 E. 26th St., New York 10

Check Plan A or B

☐ **A. Special Subscription Plan**

Enter my subscription to the new Tax Practitioners' Library. I understand that I will receive at once the first three volumes listed below, and subsequent volumes immediately upon publication. I will remit for books as received, at the special Subscribers' Price—only $8.50 per volume.

Arm's Length Transactions — Holzman
Thin Capitalization — Lore
The Tax on Accumulated Earnings — Holzman
Assignment of Income — Summa
Essentially Equivalent to a Dividend — Seghers
Evasion vs. Avoidance — Gutkin
Ordinary and Necessary Expenses — Carson-Weiner
Repairs vs. Capital Expenditures —Gordon-Wriggins
Sound Business Purpose — Holzman
Travel and Entertainment Expenses — Schorr
Unreasonable Compensation — Peloubet-Halsey

( ) Check Enclosed (Publisher pays postage) ( ) Bill Me ( ) Bill Firm

☐ **B. Ship, as available, the volumes checked below.** Bill at the regular price of $10 per volume:

☐ Arm's Length Transactions — Holzman
☐ Thin Capitalization — Lore
☐ The Tax on Accumulated Earnings — Holzman
☐ Assignment of Income — Summa
☐ Essentially Equivalent to a Dividend — Seghers
☐ Evasion vs. Avoidance — Gutkin
☐ Ordinary and Necessary Expenses — Carson-Weiner
☐ Repairs vs. Capital Expenditures —Gordon-Wriggins
☐ Sound Business Purpose — Holzman
☐ Travel and Entertainment Expenses — Schorr
☐ Unreasonable Compensation — Peloubet-Halsey

( ) Check Enclosed (Publisher pays postage) ( ) Bill Me ( ) Bill Firm

NAME ..... FIRM .....

ADDRESS ..... CITY ..... ZONE .....

STATE JT-1

THE RONALD PRESS COMPANY • New York 10

sion. As a matter of fact, there might be some concern about whether we, as certified public accountants, should have any further interest in the whole problem. After all, it would appear to be quite true that as individual members of the profession of certified public accountants, we are obviously at least indirect beneficiaries of the present complicated and inequitable tax situations.

"The greater the complexity of the tax law, the more numerous are the opportunities for tax savings with adequate and thorough tax planning. Who is better equipped to participate in this tax planning than the certified public accountants? Would it not be more logical for us to remain silent and let the well-organized pressure groups of the country take advantage of the political aspects that are involved? The greater the activity of these various organized groups, the greater the complexity of the tax law, the greater the opportunity for tax savings and the greater the area for tax planning.

"But is our duty discharged at this point? Should we remain silent?

The responsibility of CPAs

"I submit that no conscientious, informed professional man has any right to remain silent after he has recognized the facts of the present situation. And if that is true for the individual professional man, it is certainly true to a greater extent for our professional organization, the AICPA.

"To deny any responsibility on our part is merely to state that our only concern is our own selfish, material welfare. Do we not have any civic responsibility? Do we not have an obligation to our fellow citizens? Let's be realistic. If informed professional men such as ourselves, individually and through our professional organization, do not assume any responsibility for objectivity in regard to tax equity, just exactly who will?

"I submit that the realization that something must be done and willingness to take the lead in doing it, must come from those citizens who are sufficiently informed and sufficiently interested to bring to the problem a fair-minded and objective sense of equity. Over the past few years, the Institute has undertaken Herculean efforts at great financial cost to maintain the position of CPAs in the field of tax practice. If we don't hesitate to affirm our rights in the field of Federal tax practice, how can we then turn around and assert that we have no obligation with respect to the equity and propriety of the taxing statutes that underly that field of practice?

A long-range study by the Institute

"I submit that the AICPA has the specific civic and professional obligation to undertake, on their own, a comprehensive study of the Code, a study that is long-range in character—a study that disregards the multiplicity of current technical problems and is directed rather towards the long-range objective of equity and fairness in our tax law. Such a project will be expensive in character. Adequate research staffs are costly. Satisfactory working facilities do not come cheaply. But, gentlemen, there is no aspect of the cost in money and effort involved in this project that is anywhere near comparable to the cost and effort that has been expended over the years to maintain the position of certified public accountants in the field of Federal tax practice.

"Our own selfish, long-range, personal and material interests require that we assume this civic, moral and professional responsibility. Our own considerations dictate that we assume the leadership in trying to achieve a more equitable tax law, a tax law that levies an assessment on the public in proportion to their ability to pay, with a minimum of special favor, special treatment and special exemptions to special interests. Only if that is done will we have equity in our internal revenue law! Only if that is done, will we have discharged the full extent of our professional responsibility as certified public accountants."

BINDERS for The Journal of Taxation are available; each binder holds two volumes (12 copies). Price: $3 each, plus shipping. Specify whether binder is wanted for Vols. 1 & 2 (June '54-June '55), Vols. 3 & 4 (July '55-June '56) Vols. 5 & 6 (July '56-June '57 or Vols. 7 & 8 (July '57-June '58). Order from The Journal of Taxation, 147 East 50 Street, New York 22.

Tax-season pressure ups symptoms of heart trouble

WORK CRISES—or tax deadlines, to put it plainly—have now been found by medical research to bring about a definite increase of heart trouble among tax men. Research conducted by Drs. Ray H. Rosenman and Meyer Friedman, San Francisco, establishes this point. In a report at the recent scientific meeting of the American Heart Association, they pointed out that laymen and practicing physicians generally believe that occupational stress and tension (not to be confused with nervous anxiety, worry, or neurosis) is an important factor in the increasing frequency of coronary thrombosis among upper and middle class persons of this ond other industrialized nations. Nevertheless, researchers investigating the cause of arteriosclerosis have widely disregarded the possible importance of this form of socio-economic stress. We have therefore studied the effects of severe work stress on two factors of known importance in the development of coronary artery thrombosis, namely, the blood cholesterol content and the blood clotting time.

These factors were determined at bimonthly intervals in 40 volunteer tax accountants during January to June, 1957. At phasic times during this period, such persons are subjected to severe work stress imposed by the several "deadlines" in the tax calendar, with marked "lulls" in their work activity in the intervals between such deadline dates.

The results of the study clearly indicated that periods of severe occupational or other unusual stress consistently led to a marked hastening of the blood clotting time, and to rapid and frequently marked increases of blood cholesterol levels. These striking changes were not found to be due to any differences in weight, exercise, diet, or general health.

It is believed that these data provide clearcut evidence of the importance of the role of socio-economic stress and associated emotional tension in the pathogenesis of coronary artery thrombosis. ☆

Another revision in PLI series

"VALUATION PROBLEMS," by Montgomery B. Angell, is the most recent in the series of monographs on Current Problems in Federal Taxation to be published in a new and revised form by the Practising Law Institute. The book covers such subjects as definition and determination of fair market value, methods of valuation, and the trial procedure of a valuation case. Copies of this monograph, revised up to September, 1957, may be obtained from the Institute. ☆

NEW DEVELOPMENTS IN

State & local taxation

EDITED BY JOSEPH P. STAPCHINSKAS

Advisory committee criticizes real property assessment procedure in N. Y.

An advisory committee of officials and taxpayers has just completed a survey of the real property assessment procedure in the state of New York, and submitted its first report. Many tax men consider that the criticism they made of New York methods is equally applicable to other states. The committee summarized its findings and recommendations as follows:

A. The real property tax is the foundation of the fiscal structure of local government in New York State. Nearly half of all local government revenue comes from this source. While the property tax has played a diminishing role in financing local government in this state during the past 20 years, it is still by far the principal source of local tax money.

B. Assessment rolls determine the proportion of the total tax levy to be imposed upon each individual parcel of property in a tax unit. Whether the tax burden is fairly apportioned depends on the accuracy of assessments on the roll.

C. Many assessment rolls contain substantial inequalities among assessments on individual parcels. These inequities seem to be greater and more prevalent in the smaller than in the larger units. If the property tax is to continue to be a strong element of local government finance, inequalities must be corrected.

D. Many factors have contributed over the years to the unsatisfactory condition of numerous assessment rolls. Among them are:

1. Drastic dislocations in market values during the depression and the war and postwar periods, rapid growth and movement of population and industry, and recent developments in construction methods and techniques have increased the difficulty of the basic valuation task.

2. The language and form of the general laws on real property taxation in this state are obsolete and have been complicated and confused by numerous amendments during the 60 years since their original enactment. These laws should be clarified and simplified. . . .

3. The law directing assessments at 100% of full value has not brought about that result and there is no reason to believe that it will. Instead, it has provided a false guide to taxpayers, leading many to believe that they are favorably treated so long as their assessments are under full value. Actually, they may be substantially overassessed in relation to other property on the roll.

An attempt to maintain 100% full value assessments would require changes in most assessments every year. This would increase taxpayer confusion and not necessarily improve assessment equality.

Since it is unenforceable and ineffective, the direction to assess at full value has led to disregard for the law and has impaired public respect for the integrity of assessors. . . .

As a first step toward a better assessing system, the committee has recommended that the direction to assess at full value be revised to direct that all properties on an assessment roll shall be assessed at a uniform percentage of full value.* This will provide a practical foundation for development of a system in which taxpayers can perform their full role in achieving assessment equality.

It should be pointed out that the amendment recommended by the committee would not enhance the benefits of veteran or similar exemptions nor will it affect state aid, tax or debt limits, or the apportionment of county or joint school district taxes.

4. In too many localities, the office of assessor has been a part-time job for several persons receiving part-time pay, and this has tended to minimize interest in and responsibility for quality work.

Where the assessing task can be performed by one full-time or part-time professional person, only one assessor is needed. He could be authorized to serve more than one unit and to perform other duties for the localities he serves, in capacities compatible with his duties as assessor.

5. Many assessors enter upon their assessing tasks without adequate knowledge and experience. The advantages and disadvantages of various methods of selecting assessors, including their effect on the qualifications of assessing personnel, are being reviewed by the committee.

6. Training facilities available to assessing personnel are inadequate. No Assessors Manual had been provided statewide until the volumes sponsored by this committee were issued this year.

Coordinated and continuing training opportunities are needed for assessing personnel. This committee plans to develop recommendations for a comprehensive training program to be cooperatively sponsored and financed.

7. In most localities, assessors have not been provided with adequate expert or advisory services. Advisory services should be made available to assessors in respect to types of property difficult to value.

8. Many assessors lack basic equipment and records necessary to high quality performance of their duties. Most localities, for example, operate without tax maps and property record cards. These and other tools needed for good assessing should be provided.

9. Realizing the lack of adequate public understanding of the laws applicable to local assessing and their effect, assessors sometimes defer badly needed revisions of assessment rolls because of their reluctance to run the risk of possible vigorous criticism and complaint by the uninformed or misinformed taxpayers of their home community. Public information programs in connection with revaluations, efforts by civic and taxpayer organizations to inform their members, and a thorough clarification of the laws pertaining to assessment, could help develop the community understanding needed.

10. Many localities charged with

*A small minority of the Committee dissents primarily on the ground that continuation of the direction to assess at 100 percent of full value, whether or not it is carried out, will lead to more uniform and better assessment practices.

assessing duties have not provided funds sufficient to finance good assessing systems. Committee studies indicate that good assessing is not expensive compared with the benefits it confers. Further studies are being made of the cost of an effective assessing system, the ability of localities to meet such costs and the possible role of state as well as local resources for financing.

11. In many assessing units, the only administrative review is conducted by the assessors themselves, raising questions as to its effectiveness as a practical remedy for taxpayers' relief from assessment inequalities. This type of review would be improved if it were administered by a board, the majority of whom were not directly responsible for the original assessment.

12. Judicial review is both complicated and expensive. The provision concerning stipulation of the level of assessment of other property on the roll has provided a method for reducing the expense, but further study of this important taxpayer remedy is needed.

E. No single type of system will fit the wide variety of circumstances found in this state. Certain minimum requirements, however, apply to all situations. Among these needs are:

1. Well-qualified assessing personnel adequately compensated for the time and quality of work required.

2. Effective grievance machinery for reviewing assessments.

3. Tax maps, property record cards and other equipment.

4. Technical and mechanical assistance for assessors.

5. Coordinated and continuing training opportunities for assessing personnel.

6. Professional advice, particularly in respect to properties difficult to value.

7. Enough security to permit the assessor to carry out his duties without fear of being discharged as a result of doing a good job.

8. A standard for equality among assessments which is clear, which is the same for the original assessment as for adjustments on review and which is enforceable by the taxpayer.

9. Assessing procedures as simple as possible and consistent with the requirements of equality and the need for taxpayer information and notice.

10. Schedules of dates which coordinate with related operations of local and state government.

11. General state laws pertaining to real property taxation which are clear and easy to understand.

F. Cooperation and willingness to be helpful must be forthcoming from all levels and units of government, their officials and their taxpayers, if assessments are to be substantially improved in a short period of time. In addition, more widespread understanding of assessment processes, the meaning of assessment equality, and taxpayers' rights and remedies is required before any system can operate effectively.

G. Although problems involved in improving local assessment practices are complex and solutions will not come easily, there have been no facts developed which would indicate any need or desirability of departure from the established principle that assessment of real property is a function of local government in New York State.

By the high level of its performance in other areas and by the vigor and effectiveness of its response to some of the assessment problems disclosed recently, local government has demonstrated it can, and it intends to, increase its competence in the assessment field.

H. Assessing is one of the important functions of the cities, towns and villages in this state. . . .

Because of the importance of strengthening local government by improving this operation rather than reducing its powers, a comprehensive effort should be made to revise the existing system, so that, if possible, it will produce good assessments without mandated centralization.

1. The state and the counties have a common interest and responsibility in providing to the localities the greater encouragement, guidance and assistance they need to achieve better assessments. . . . ☆

New state & local decisions

Mileage allocation formula upheld despite actual loss in state. For Arkansas income tax purposes, two interstate passenger bus services reported losses in years in which their total operations produced a substantial profit. They were subjected to deficiency assessments by the Arkansas Commissioner of Revenues when it was determined that they had not used the statutory method The statutory apportionment formula was based principally on the ratio of mileage traveled within the state to total mileage. The taxpayers contended that because of a comparatively low traffic density in Arkansas, this formula produced an unrealistic and unconstitutional result. The court took the position that any formula, if apparently fair, should be upheld unless the taxpayer sustains the burden of proving it arbitrary. It held that in this case the low traffic density within the state was not sufficient to prove the formula inapplicable. *Transcontinental Bus System, Inc.*, Sp. Ct. Ark., 5/6/57.

Local privilege tax unconstitutional. An annual privilege tax of $250 was imposed by the city of Opelika, Alabama, on firms engaged in the wholesale grocery business delivering groceries in the city from points outside the city. The firm on whom the tax was imposed was a Georgia corporation whose only contact with Opelika was the solicitation of orders and the interstate delivery of goods. The Supreme Court ruled that it had banned a tax of this type as an interference in interstate commerce in *Nippert* and in *Memphis Steam Laundry Cleaner, Inc.* It held that the ban of those cases was particularly pertinent to the case at hand since Opelika placed no comparable flat-sum tax on local merchants but subjected them to a graduated gross receipts tax which would not total $250 until gross sales reached $280,000. *West Point Wholesale Grocery*, U. S. Sp. Ct., 6/16/57.

Trucker, wholly interstate, subject to Wisconsin tax. Taxpayer, a foreign freight transportation corporation, was not admitted to do business in Wisconsin. Its business in Wisconsin was wholly interstate in nature; it solicited no business in the state. The company owned no property and had no employees in the state other than its interstate trucks and the drivers thereof. The Board held corporation to be subject to the Wisconsin direct net income tax on the authority of *Knox Motor Service, Inc.*, Wis. BTA, 6/13/56. *Moore Motor Freight Lines, Inc.*, Wis. BTA 9/26/57.

Massachusetts apportionment upheld in Breck case. Breck, a Massachusetts corporation having its principal office and plant in that state, challenged the inclusion of interstate receipts in the numera-

tor of the receipts fraction of the three-factor formula by which its net income was apportioned. The receipts in question were derived from the out-of-state delivery of goods from Massachusetts stocks pursuant to sales negotiated by taxpayer's personnel who were not operating from or under the direction of a non-Massachusetts office. Reversing the Appellate Tax Board, the Massachusetts Supreme Judicial Court upheld the includability of the interstate receipts in the numerator of the receipts fraction, noting that such a method of apportioning the net income tax base in computing the excise tax liability of a domestic corporation had received the sanction of the U. S. Supreme Court. *Breck,* Sp. Jud. Ct. Mass., 7/3/57.

Sales tax on truck lease upheld despite its use interstate. Taxpayer, a Tennessee corporation, leased trucks to another Tennessee corporation which used them in both interstate and intrastate transportation. Under terms of the lease, the lessee paid a flat rental plus a stipulated amount per mile. Taxpayer, the lessor, paid all expenses incurred in the operation of the trucks except drivers' wages. Tennesse imposed sales tax on these receipts. Under Tennessee law, the sales tax is imposed on "dealers" which is defined to include persons leasing tangible personal property. The court construed the tax to fall upon the seller or lessor irrespective of whether the lease shifted the economic burden to the buyer. In the case on hand, the court ruled that the taxable event was the lease made and not the use to which the trucks were put in interstate commerce even though the lease made mileage a basis for a portion of the price paid by the lessee, and it upheld the assessment. *Central Transportation Co.,* Sp. Ct. Tenn., 7/29/57.

Refund to handler allowed. Taxpayer delivered aviation fuel obtained from oil companies to airlines under an exclusive contract with the New York Port Authority by which it was prohibited from having an interest in any of the fuel which it delivered. It was required by this agreement to make good any losses or shortages in the fuel through evaporation, spillage, etc. The handler applied for a refund on taxes paid on such losses, but had its claim denied by the New York Tax Commission. The Supreme Court ruled that the taxpayer was entitled to the refund it claimed. The legal position of the tax commissioner was that the claimant was not a purchaser and therefore was not entitled to a refund allowed persons who buy tax-paid motor fuel and consume it for purposes other than highway use. The Court, however, held that the contract which made the handler liable for lost fuel in effect made it a purchaser. The fact that the fuel was consumed and then purchased rather than purchased and then consumed did not adversely affect the right of refund, the Court said. *Allied New York Services,* Sp. Ct., N. Y., App. Div., 7/23/57.

Tax on trading stamps redeemable by others invalid. A 2% tax on the gross receipts of merchants using trading stamps was enacted by the 1957 session of Tennessee's legislature, effective on August 1. The tax was imposed on merchants using stamps which entitled the purchaser to receive merchandise from persons or firms other than the seller either free or below the market price. The act excluded from the tax merchants using stamps redeemable from their own merchandise. In holding the tax unconstitutional, the court found no real distinction between a merchant using the services of a trading stamp company and one who gave and redeemed his own stamps. To tax one and not the other, the court said, was arbitrary and unreasonable and a violation of the state constitution. *Logan's Supermarket,* Sp. Ct. Tenn., 7/9/57.

The reports here on significant new state tax decisions are provided through the cooperation of the Federation of Tax Administrators. They are adapted from Tax Administrators News.

CLASSIFIED ADVERTISING

Classified advertising will be accepted for publication for help wanted, situations wanted, business opportunities, practices for purchase or sale, purchase and sale of merchandise, and similar items. Rate per insertion: 60¢ per line, minimum, $3. Address copy for advertisement, together with check, to The Journal of Taxation, 147 East 50th Street, New York 22. Replies should also be sent to this address.

SITUATION WANTED—FEMALE

Tax attorney (woman): ten years tax department CPA's; research Federal, state, local; returns, protests, memoranda; intelligent, versatile. $6500-$7000. N. Y. area only. Box 134.

SITUATION WANTED—MALE

Atty-CPA (LL. M. Taxation) with several years experience in all phases of Federal income, estate and gift taxation desires position of responsibility with law firm or corporation. Chicago area preferred. Box 137.

INDEX OF NEW DECISIONS REPORTED IN THIS ISSUE

NEW DECISIONS are listed below by the single significant word in the citation, generally the taxpayer's last or principal name. The number is page where summary will be found.

Achong	95	Funk	87	Patten	79
Alleghany Corp.	95	Funkhouser	96	Patton	95
Allen	111	Gant	96	Peebles	95
Allied	129	Gooding	86	Peurifoy	87
American Envelope	96	Goldberg	116	Pipe Estate	71
Barrios Estate	95	Goldstein	93	Prunier	80
Bartram	71	Gowans	94	Rogers	123
Bass	94	Gregory	97	Russo	123
Benjamin Estate	80	Guardian Investment Co.	97	Santos	87
Best Lock Corp.	96	Gulledge	79	Schroeder	123
Blum Estate	100	Gunn	123	Scott	94
Bostick	86	Hill	111	Shelton	71
Brandeis	94	Hollander	86, 122	Shirah	86
Breck	129	Jennings	87, 111	Shoe Corp. of America	96
Broide	116	Jernigan	111	Silverman Estate	71
Brubaker	96	Kaiser	87	Simpson	100
Budd	97	Klamath	80	Smith	79
Bullock	96	Knox Motor	128	Smith Estate	80
Cantor	123	Krome	110	Peebles	95
Casey	80	Lewis	123	Spence	94
Central	129	Loeb Estate	71	Steuart Bros.	94
Clark	86	Logan's	129	Suter Estate	80
Cobb	86	Lyman Trust	79	Transcontinental	128
Cohen	122	Madison	111	U. S. Pipe	111
Cromwell Estate	70	McCall	87	VanDyke	96
Damski	122	McNair	87	Wainer	111
Deitsch	86	Meyer	97, 123	Weinstein	97
Duval Motor	95	Miller	121	Weisberger	71
Empire Ordnance	111	Miller Estate	71	Westerhaus	87, 96
Federated Mutual	121	Mills	123	West Point	128
Field Estate	70	Moore	128	Williamson Estate	79
Flambolis	96	Murdock	79	Zipp	80
Frank	123	Newman, Andrew	95	Young	87
French Broad Ice Cream	79, 96	Nixon	100		
		Parker	116		

REVENUE RULINGS: The first number is that of the ruling, the second is the page number where a summary of the ruling will be found.

57-350	121	57-537	95
57-421	121	57-538	100
57-446	71	57-539	97
57-448	71	57-540	80
57-450	97	57-541	80
57-451	100	57-542	121
57-482	80	57-548	95
57-483	100	57-560	87
57-484	86	57-561	86
57-501	111	57-565	94
57-508	94	57-567	121
57-510	94	Notice 1957-32	121
57-514	94	Rev. Proc. 57-30	111
57-517	94	57-33	111
57-522	87	Spec. Rul. 4/11/57	121
57-523	94	4/18/57	121
57-530	71		
57-536	87		

Alexander's Federal Tax Handbook

"the most complete one volume work on business and personal tax liability"

22nd EDITION • 1958

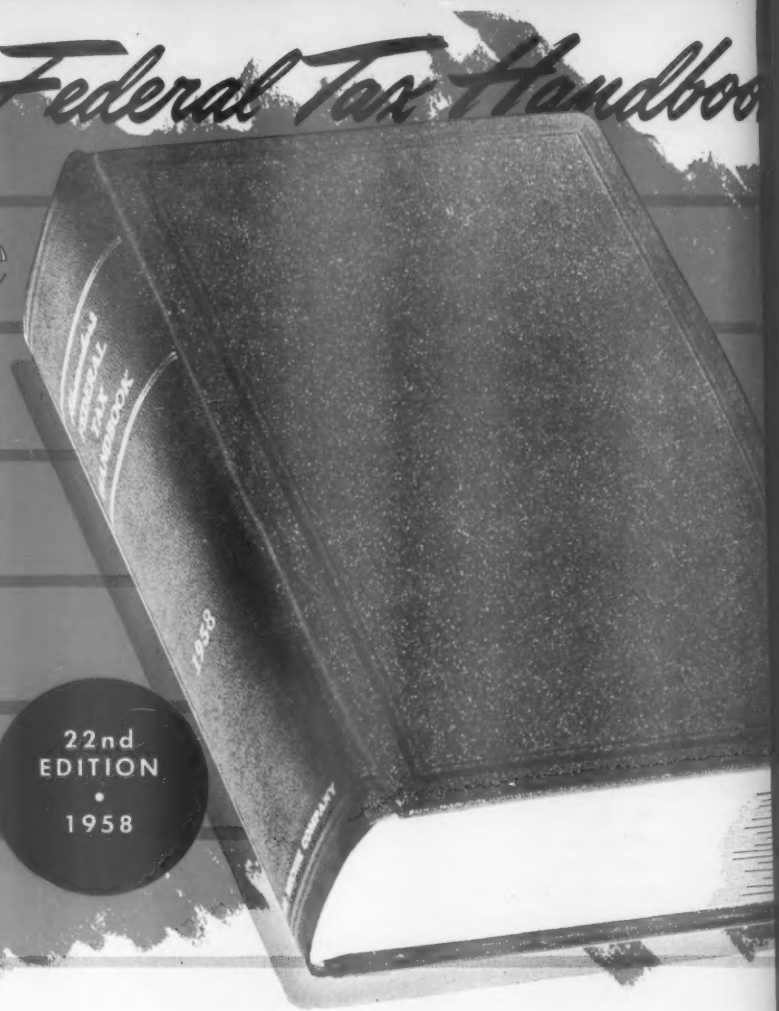


TABLE OF CONTENTS, by chapters

1. Introduction • 2. General Pattern of the Federal Income Tax • 3. Returns, Exemptions, and Rates for Individuals • 4. Income—General Principles • 5. Income—Compensation for Personal Services • 6. Income—Dividends and Interest • 7. Income—Insurance Proceeds and Annuities • 8. Income—Miscellaneous Inclusions and Exclusions • 9. Inventories • 10. Deductions for Trade and Business Expenses • 11. Depreciation and Depletion • 12. Sales and Exchanges—Basis • 13. Sales and Exchanges—Recognition of Gain or Loss • 14. Sales and Exchanges—Capital Gain or Loss • 15. Installment and Deferred Payment Sales • 16. Bad Debts and Losses • 17. Interest, Taxes, and Contributions • 18. Medical Expenses; Other Deductions; Standard Deduction • 19. Accounting Methods • 20. Farm Income and Expenses • 21. Partnerships—Formation • 22. Partnerships—Operations • 23. Partnerships—Sales, Exchanges, and Distributions • 24. Trusts • 25. Decedents and Estates • 26. Corporations—Income, Deductions, Rates, and Returns • 27. Corporations—Special Categories • 28. Corporations—Formation and Reorganization • 29. Corporations—Liquidation • 30. Returns • 31. Pay-as-You-Go—Withholding • 32. Pay-as-You-Go—Declarations and Payment of Estimated Tax • 33. Nonresidents and Aliens • 34. Social Security Taxes • 35. The Federal Gift Tax • 36. The Federal Estate Tax—Inclusions and Exclusions • 37. The Federal Estate Tax—Valuation, Deductions and Credits, and Returns • 38. Miscellaneous Federal Taxes • 39. Tax Administration • 40. Procedure in Tax Controversies • 41. Tax Planning and Control

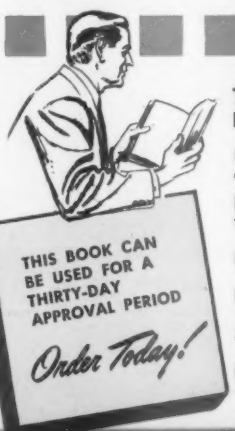
Code Finder

Index

ALEXANDER'S FEDERAL TAX HANDBOOK, edited by Robert M. Musselman, is the only complete one-volume reference text on all Federal taxes including income, estate, gift, social security, withholding, excise and miscellaneous taxes.

Even the tax expert with an extensive tax library will find this one-volume work a handy desk companion for the quick answer to the many problems that arise in daily practice.

As one customer wrote, "We have been advised that the current edition of this book is one of the very best available, and we would like to add a copy to our library."



THE MICHIE COMPANY
LAW PUBLISHERS, CHARLOTTESVILLE,

Please send me ..... copies of the 1958 E of Alexander's Federal Tax Handbook at $20.00

☐ Send on approval. I understand that I may r the book if I am not fully satisfied.

Name.....

Firm.....

Address.....

City.....Zone.....State.....

dited by
me ref-
ate, gift,
s taxes.
will find
e quick
tice.
that the
vailable,

TTESVILLE,
f the 1958 E
ok at $20.00
that I may r

.....State.....